

## Leithner Letter No. 114-116 26 June - 26 August 2009

*A panel of top business leaders testified before Congress about the worsening recession Monday, demanding the government provide Americans with a new irresponsible and largely illusory economic bubble in which to invest. "What America needs right now is not more talk and long-term strategy, but a concrete way to create more imaginary wealth in the very immediate future," said Thomas Jenkins, CFO of the Boston-area Jenkins Financial Group, a bubble-based investment firm. "We are in a crisis, and that crisis demands an unviable short-term solution."*

*The current economic woes, brought on by the collapse of the so-called "housing bubble," are considered the worst to hit investors since the equally untenable dot-com bubble burst in 2001. According to investment experts, now that the option of making millions of dollars in a short time with imaginary profits from bad real-estate deals has disappeared, the need for another spontaneous make-believe source of wealth has never been more urgent.*

*Congress is currently considering an emergency economic-stimulus measure, tentatively called the Bubble Act, which would order the Federal Reserve to begin encouraging massive private investment in some fantastical financial scheme in order to get the nation's false economy back on track.*

*Demand for a new investment bubble began months ago, when the subprime mortgage bubble burst and left the business world without a suitable source of pretend income. But as more and more time has passed with no substitute bubble forthcoming, investors have begun to fear that the worst-case scenario – an outcome known among economists as "real-world repercussions" – may be inevitable. "Every American family deserves a false sense of security," said Chris Reppto, a risk analyst for Citigroup in New York. "Once we have a bubble to provide a fragile foundation, we can begin building pyramid scheme on top of pyramid scheme, and before we know it, the financial situation will return to normal" ... "America needs another bubble," said Chicago investor Bob Taiken. "At this point, bubbles are the only thing keeping us afloat."*

[Recession-Plagued Nation  
Demands New Bubble To Invest In](#)  
*The Onion (14 July 2008)*

## Have We “Hit Bottom” Yet? I Don’t Think So!

For more than a year, two questions have obsessed investors, finance journalists, media talking heads and others. The Australian form of these questions is:

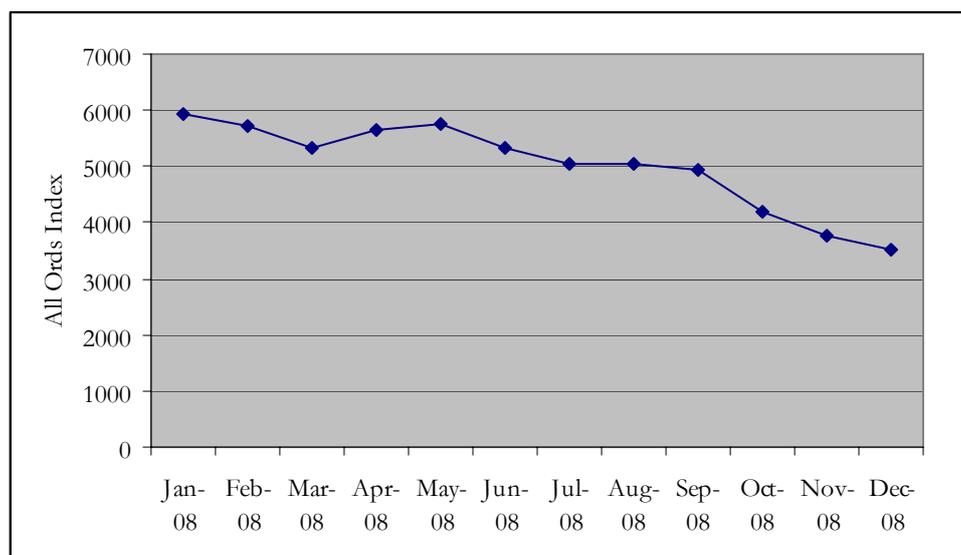
1. Has the All Ordinaries Index (AOI), which reached an all-time high of 6,873 on 1 November 2007 and fell to 3,145 on 6 March 2009, “hit bottom”? And if so, when will it reverse course and recoup its losses?
2. What is the AOI’s “fair value”? Are stocks, considered as a whole, presently “undervalued,” such that he who buys them today will (despite some nausea encountered over the short-term) be handsomely rewarded in the next several years? Or do stocks remain “overvalued” and susceptible to further falls? If so, how low might the AOI go?

Answers to these questions appearing in Anglo-American mainstream media have been nothing short of astonishing. Journalists, “strategists” and pundits have bothered neither to clarify their premises and reasoning, nor to describe the evidence upon which they have based their views. (Perhaps that’s because many of these views are, in the most literal sense of the term, baseless.) Instead, breezy assertion and wishful thinking has ruled the roost. “Five-year Winning Streak Has a Good Shot at a Sixth” (*USA Today*, 2 January 2008) was typical. “2008 could start out bumpy, but signs point to a sweet finish,” it concluded. According to Brian Westbury (“The Economy Is Fine (Really),” *The Wall Street Journal*, 28 January), “it is hard to imagine any time in history when such rampant pessimism about the economy has existed with so little evidence of serious trouble.” He continued: “Because all debt rests on a foundation of real economic activity, and the real economy is still resilient, the current red alert about a crashing house of cards looks like another false alarm. Warren Buffett [is] buying, and ... the bench of potential buyers on the sidelines is deep and strong. Dow 15,000 looks much more likely than Dow 10,000. Keep the faith and stay invested. It’s a wonderful buying opportunity.”

In the Lucky Country, consternation and even indignation prevailed early in 2008. “The savage nature of the sell-down through-out the Asia-Pacific region [which featured twelve consecutive days of losses in Australia, culminating in a drop of 3% on 21 January] stunned market veterans, who labelled it irrational,” reported *The Australian* on 23 January. As a result, “Many brokers can no longer feel confident predicting just where or when the bottom of our market will be. The real bears are calling it 5,000 points.” But the herd remained undeterred. A major bank’s head of economic research told *The Weekend Australian* (16-17 February) “the profits trend is still upward as the economy continues to grow. This will ultimately be reflected in share market performance. It’s expected that there will be 8% profit growth over the next year ...

and we expect the share market to be 6,300 by year end, which is a 12% gain against its level today at 5,650.” And the chief economist at one of Australia’s biggest insurers and funds managers told *The Australian* on 20 February: “while further falls in share markets are likely and the next six months will remain volatile, we expect the U.S. downturn and slump in shares to be relatively short-lived. Things could be on the mend in the second half.” The author of the article added: “many economic experts will look like dills if we see a 10-15% slump [of stocks] from here.”

**Figure 1:  
The Mainstream’s “Strong Fundamentals” During 2008**



By his own standard, this columnist soon looked like a dill. On 27 February he wrote: “with the stock market down 18% since 1 November, sending trainloads of highly leveraged investors [sic] to the cleaners, a timely question needs to be asked. With the market at these attractive levels, should we now think about a margin loan?” Then, without a scintilla of evidence, he alleged: “it could be argued that if we’re at or near the bottom of this share price rout, then getting more exposure to the eventual rising market could make sense.” In case readers missed his point the first time, he repeated it: “If we are near the bottom of this share price slump, why not get more of the positive days ahead by gambling on margin loan products?” He calmed readers about the risk of this gamble: “the ASX would have to fall from where it is now around 5,500 to say 4,400 before you got a margin call. And that’s highly unlikely. The reality is if this happened we wouldn’t be talking about using the R-word for recession but the D-word for depression.” Although its truth bore no relation to his intention, the columnist’s conclusion was sensible: “Eventually equity markets will have to reflect fundamentals such as the domestic economy and profits.” Alas, he then ended with sheer fantasy of breathtaking proportions: “Valuations are too cheap to support weaker stock market levels.”

The fever of delusion and denial raged into the autumn. On 8-9 March *The Weekend Australian* alleged in an editorial: “it has been clear for some time that movements on the [ASX] are at odds with economic fundamentals. Unlike the U.S., Australia is not headed for recession; yet the Australian market has fallen further from its high in November than has the U.S. market.” On 12 March a like-minded broker told *The Australian*: “I don’t think I’ve experienced anything quite like this before. When the fundamentals of the economy, inflation, interest rates and unemployment are decidedly better than they were in 1987, and with share prices plummeting the way they have, something seems dysfunctional here. There have been a few times in the past half century when there have been excellent value opportunities around and people didn’t realise it. [This is one of those opportunities.]” Another broker babbled on 18 March: “I think the market wants to see the [All Ordinaries] Index below 5,000 and it probably needs to go there to get past the psychological level. It wants to see some value where it is well and truly oversold.”

A funds manager confidently told *The Australian Financial Review* on 20-24 March: “we believe that the market is close to a bottom. This correction, in percentage terms, is the largest since the 1987 crash. One logical [sic] downside target would be a 50% correction of the entire bull market run since March 2003. On this basis, our downside target is 4,800 points on the All Ordinaries, if we haven’t already bottomed.” And let’s not forget *The Australian’s* resident dill. On 26 March he wrote: “personally, I think timing is often hard and so I like time in the market, but I prefer to do timing and time in the market. And the time must be close to start getting in.” Reuters quoted a broker at one of the country’s largest financial institutions on the 28<sup>th</sup>: “if you were to apply a worst case scenario across our market, a possible low may be 5-10% lower from where we are at the moment” [i.e., 5,330].

A group of “experts” polled by *The Weekend Australian Financial Review* (24-27 April) agreed. They “predict a tough few months for domestic equities ... However, most of the experts expect the local share market to be back on a bullish footing by the end of the year. A majority predict the benchmark index will end the year above 6,000.” According to an article in *The Adelaide Advertiser* (28 April), “the share market is close to the ‘point of maximum investor opportunity’ says [a major investment institution]. While the start of the year had been brutal, investors should not be too pessimistic about the outlook for local and global share markets.” This institution’s strategist “could not be sure that the market correction was over, but its 26% peak-to-trough fall so far was ‘well within the ballpark’ of previous corrections, except the 1987 crash where stocks fell 49% after rising 90% in the previous 12 months. ‘If we’re not at the bottom we must be very close.’ He said listed property trusts were starting to look attractive, with some trading at big discounts to net tangible assets. Overseas share markets also offered significant long-term value. ‘It’s difficult to be pessimistic about the local market. Valuations, though high relative to other markets, look attractive in absolute terms.’”

A panel assembled by *The Weekend Australian* (14-15 June) carried this doggedly delusional mood into the winter. One member advised that investors “should not be alarmed in the sense that they should get used to [the increased volatility of stock prices]. But equity markets and the underlying economy and the profits that drive equities, we believe, remain solid.” Another said “the signs seem to be that the worst of the downturn in the U.S. economy is happening around now. The data [haven’t] been worse. If anything, the recent indicators have been on the high side.” Regarding the prices of stocks, a third expert said “we expect to see ... a rising trend and particularly when we get through June year-end. We’ll probably see a better performance into the August-September period.” A fourth confidently prophesied “the market is probably going to be flat for the next six months. The best outcome will be that it goes back to 6,000 and the worst outcome is that it’s flat at 5,500. By the end of the year, all of these issues are going to be resolved. The domestic consumer issue is going to be resolved and the U.S. Federal Reserve policy will be resolved and start tightening and a return to normal conditions. Perhaps the only issue that will be unresolved will be the global inflation outlook.”

### **Let’s Now Consider Some Facts: An Overview of Aussie Bear Markets**

I’ll spare you the gibberish the mainstream uttered throughout the July-December half.<sup>1</sup> Soft words were many, but systematic examinations of hard numbers and the historical record were nowhere in sight. In particular, virtually absent was any identification and description of past bear markets.<sup>2</sup> The All Ordinaries Index (AOI) was created in 1980, but can be reconstructed back to 1874.<sup>3</sup> Table 1 lists the eight most severe bear markets (as measured by the

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<sup>1</sup> In brief, events which by the end of the year produced the worst annualised result in Australian history continued to take them completely by surprise. In response, they fixated upon the causes of and the cures for the Great Depression – which, of course, they misdiagnosed and misprescribed. Then they proceeded to draw an analogy between their misinterpretation of the current situation and their misunderstanding of the 1920s and 1930s. The “consensus” was as appalling as it was laughable: all and sundry demanded – allegedly in order to prevent another Depression – that governments must continue and intensify the very policies that caused and prolonged the actual Depression! In sharp contrast, see [All We Are Sayin’ Is Give Free Markets a Chance, Letter 102-104](#) and [Letter 108-110](#).

<sup>2</sup> Vanguard, one of the world’s biggest investment managers, says “One generally accepted definition of a bear market in stocks is a price decline of 20% or more over at least a two-month period as measured by a stock market index such as the Standard and Poor's 500 Index (S&P 500) which consists of the stock prices of 500 U.S. corporations.”

<sup>3</sup> The AOI has usually comprised 500 companies, typically selected on the basis of their size and the number of their shares that routinely trade on the Australian Securities Exchange (as opposed to those owned by founding or controlling interests that do not trade them). The ASX began as six separate exchanges located in the colonial capitals. In 1903, they held their first interstate conference, which led to the formation (in 1937) of the Australian Associated Stock Exchanges. Through this organisation the state-based exchanges estab-

severity of the AOI's descent and the length of time required to recover its losses) during this 134-year interval. On average, the Index has fallen 37% from the peak of the bull to the trough of the ensuing bear market. The shallowest bust occurred during the First World War, and the most severe one in the recession of the 1970s. The journey from peak to trough has taken an average of 2.5 years. The quickest journey (after the Crash of 1987) took five months, and the longest (after the Depression of the 1890s) five years. The time required to recoup the losses of a bust (i.e., to return to the crest of the preceding boom) has taken an average of 86 months or 7.25 years. The fastest recovery occurred after the Internet Bubble, and the slowest after the Depression of the 1890s.

**Table 1: Major Australian Booms, Busts and Times Required to Recover (All Ordinaries Index 1874-2008)**

Episode	Boom Maximum	Bust Minimum	Fall fm Max to Min	Time Req'd to Reach Min	Time Req'd to Return to Boom High
Depression of 1890s	Nov 1888 (10.2)	Dec 1893 (6.5)	-36%	5.0 years	15.0 years (Dec 1903)
Great War	Jun 1914 (22.5)	Dec 1916 (17.5)	-22%	2.5 years	6.75 years (Feb 1920)
Great Depression	Jul 1929 (51.6)	Aug 1931 (27.8)	-46%	2.0 years	5.25 years (Jan 1934)
Recession of 1970s	Jan 1970 (431.2)	Jan 1974 (193.7)	-55%	4.75 years	9.75 years (Sep 1979)
Recession of 1980s	Nov 1980 (736.4)	Jul 1982 (461.4)	-37%	1.75 years	3.0 years (Dec 1983)
Crash of 1987/Recession of 1990s	Sep 1987 (2,239)	Feb 1988 (1,227)	-45%	0.5 years	8.0 years (Jan 1996)
Internet Bubble	Feb 2002 (3,392)	Mar 2003 (2,779)	-18%	1.0 years	2.0 years (Mar 2004)
Great Bubble/Great Recession	Oct 2007 (6,873)	??	??	??	??

**Implication #1:** The current bear market is among the sharpest and nastiest in Australian history. If so, then it is naïve to extrapolate – as many did early in 2009 – that the AOI will reach its nadir by the middle of 2009 and recoup its losses by 2012-2013. If a journey of average length from peak to trough is in store, then we shouldn't expect the AOI to bottom before mid-2010. Clearly, a longer journey implies a later trough. And if an historically

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lished a common set of rules and regulations – including (in 1980) the AOI. Finally, in 2004 the Australian Stock Exchange and the Sydney Futures Exchange merged and created the Australian Securities Exchange.

average rate of return (of ca. 7.5% per annum) henceforth prevails, then the Index will require no less than ten years – that is, until early 2019 – to rescale the summit it first climbed in late 2007.<sup>4</sup>

### **The Crowd Says the All Ord's P/E Is “Historically” Low: Is It Really?**

Another way to address our two questions is to compute and analyse the price-to-earnings ratio (also known as the “P/E” or “PE” ratio) of the AOI. Figure 2 plots its PE ratio on “one-year” and “ten-year” bases from 1974 (the earliest year for which I have been able to assemble valid and reliable data about earnings) to 2008. For context and comparison, Figure 3 plots these two PE ratios for the Standard & Poor's 500 Index.<sup>5</sup> To make sense of the underlying concept (it is usually applied to individual companies, and sometimes to a sector of a market, but infrequently to an entire market), regard the companies comprising the AOI in a given year as if they were a single firm. During 1974 “All Ordinaries Ltd” earned profits of \$33.97 per share. Because the average level of the Index in that year was 268, its PE ratio was  $268 \div 33.97 = 7.9$ . During 2008 it earned \$458.14 per share and the Index averaged 5,020; hence its PE ratio was 11.0.

“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

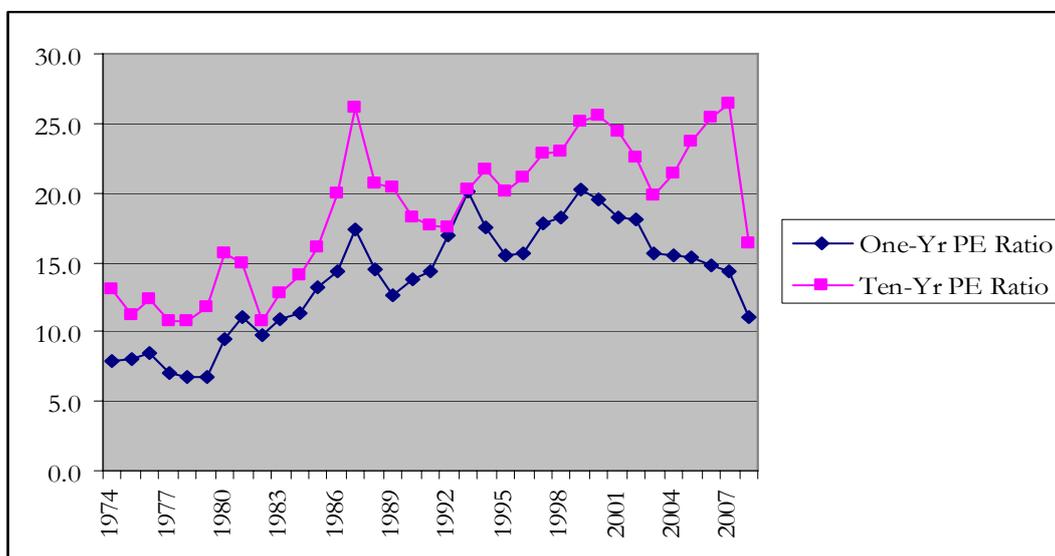
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<sup>4</sup> “Investors are bruised and confused after the worst downturn in living memory,” reported *The Weekend Australian* (7-8 February 2009), “but almost without exception they are prepared to move back into the stock market when conditions improve.” Its investigation revealed that they “do not expect to see any sign of a sustained recovery for 12-18 months, saying it could take up to three to five years for the market to reclaim the highs struck in late 2007.” It sought to convey the impression that “investors” had been chastened, had learnt lessons and henceforth would act more cautiously and adopt more modest expectations. Alas, the evidence cited in the article flatly contradicts the impression it intended to convey. In the wake of the worst 12-month result in Australian history, market participants remain extraordinarily upbeat. How so? To assert that during the next 3-5 years market indices are going to return to the all-time highs reached in late 2007 is to assert that these indices will rise by 20% per year for the next four years. Is there any precedent for such a persistent advance? Just one: the Great Bubble of 2003-2007! What's the probability that it will quickly reflate? If an historically-average return henceforth applies (see [Leithner & Co.'s Objectives and Possible Returns](#)), then from its low in March 2009 the AOI will not rescale the summit it first climbed in late 2007 before 2019.

<sup>5</sup> The S&P 500 is a value-weighted index, published since 1957 by Standard & Poor's, a division of McGraw-Hill, Inc., of the prices of 500 leading American stocks. It is considered a bellwether for the American economy and is a component of the Conference Board's Index of Leading Indicators. Scores and perhaps hundreds of managed funds, pension funds, etc. are designed to mimic the performance of the S&P 500 index. As a result, many hundreds of billions of \$US have been invested in this fashion.

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." Another advantage of this average level of earnings, Graham continued, was that it simplified the treatment of the "one off" factors that regularly distort a single year's earnings. This average "could give a really informing picture of the company's past performance." In Figure 2, the ten-year average PE for 1974 takes the AOI's "per share" earnings for each year from 1965 to 1974 (inclusive), computes their mean (\$20.60) and then divides the Index's average level for 1974 (268) by this average level of earnings. Computed on this basis, the AOI's price-to-earnings ratio in 1974 was 13.0. In 2008 the ten-year PE ratio was 16.3, and from 1974 to 2008 it averaged 18.7.<sup>6</sup>

**Figure 2: All Ordinaries Index,  
One-Year and Ten-Year PE Ratios, 1974-2008**

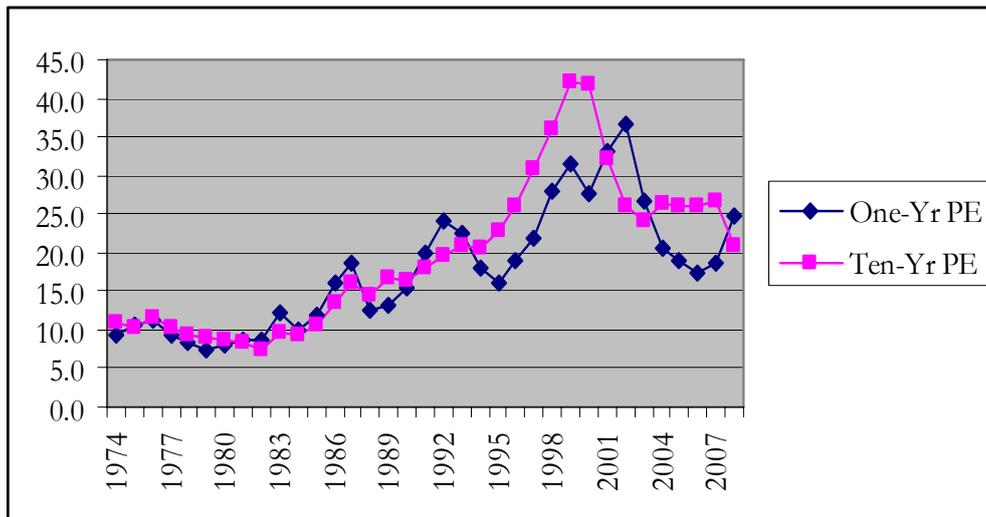


The AOI's one-year PE implies that, in order to buy \$1 of its earnings, in 1974 the investor would have spent an average of \$7.89. By December 2008, the earnings of "All Ords Ltd" had swelled to \$416.98 and the Index averaged 3,524. Its PE was thus  $3,524 \div 416.98 = 8.5$ , which was well below its average (13.8) for the entire 34-year period. Clearly, the investor seeks to outlay as little capital as possible at one point in time in exchange for the stream of earnings that he expects to receive over time. Accordingly, and other things equal, the *lower* is the PE ratio of a company, sector or overall market, the better.<sup>7</sup> For

<sup>6</sup> The ten-year measure has almost always (the nadirs of some recessions seem to be exceptions) exceeded its one-year counterpart. Why? The AOI's earnings usually rise from one year to the next. Hence its average of earnings over the past ten years is typically – and often substantially – smaller than the most recent year's earnings. Both ratios use the current year's level of the AOI as a numerator, and the ten-year measure's denominator is usually smaller than the one-year's. As a result, the former ratio usually exceeds the latter.

this reason, the battered bulls have in effect crowed: “Yes, you’ve suffered huge losses. But the Australian market’s one-year PE ratio has reached a low not seen in 20 years, and its 10-year PE ratio has reached a level not seen in more than 10 years; hence Australian stocks are cheaper now than they’ve been in decades. Stocks are a bargain, so buy them.”<sup>8</sup>

**Figure 3: S&P 500 Index,  
One-Year and Ten-Year PE Ratios, 1974-2008**



It’s important to emphasise this point because analysts, brokers, strategists and members of the commentariat say it repeatedly, emphatically and sometimes even triumphantly: stocks have become very cheap because the Australian market’s PE ratio now lies well below its “historical average.”<sup>9</sup> Alas, when they

<sup>7</sup> [A Simple Calculation](#) (*Barron’s*, 31 May 2003) by Charlie Minter and Marty Weiner provides a concise overview of the methods typically used to compute the price-to-earnings ratio.

<sup>8</sup> Such assertions are too numerous to list. For example, “the Australian market is currently trading on a one-year forward (consensus PE of 12.5 times, which is the lowest for 13 years, and well below the long-run average of 14.9 times. So there is plenty of value in the market for medium and long-term investors” (*The Weekend Australian*, 5-6 April 2008). And this: “we’ve got a historic price-to-earnings ratio sitting at 11.9. It shows there’s plenty of value in the market and buyers are going to be well-rewarded in picking up some stocks now and perhaps putting them away in the drawer for a couple of months or a year or so” (*The Australian* 16 June 2008).

<sup>9</sup> Or else they reckon, if it suits their purpose, that PE ratios are illusory or irrelevant. In an amusing mishmash of *non sequiturs* and sheer babble, *The Australian* (12 September 2007) stated “the low PER (price/earnings ratio) is usually illusory. If gearing is low, cash-flow generation is strong and earnings have low risk, then there is no real need to access debt-funding. The risk to the share price is relatively low, even if the PER is high. If, however, net debt to equity is high (100% or greater), and more debt is needed to cover a cashflow shortfall or to meet dividends, then the PER is irrelevant. The experience of the 1987 crash highlighted that buying low single-digit PER stocks did not protect the investor. On the other hand, the share prices of stocks with sound cash flows and balance sheets

invoke this average they seldom specify *which* ratio they have in mind. Usually, they seem to refer to the “one-year” ratio; occasionally, they compute a “prospective” or “forward looking” one using (an almost invariably generous estimate of) next year’s earnings; and rarely do they employ a PE ratio that uses a long-term average of earnings. In short, when they tout their “historical average” the guardians of conventional wisdom seldom designate the interval of history it covers; and virtually never do they justify it.

**Implication #2:** Figure 2 confirms the crowd’s mantra that, *by the standards of 2000-2007* (when its one-year PE ratio averaged 16.5), and *by the standards of the 1990s* (when it averaged 17.0), All Ords Ltd is – subject to the caveat that its earnings do not plunge – presently very cheap. *By the standards of the 1980s*, when it averaged 12.5, today’s market is reasonably priced but not very cheap; and *by the standards of the 1970s*, when it averaged 7.5, it is not cheap.

Similarly, the ten-year PE ratio’s trajectory contradicts the herd’s contention. Its rise from the mid-1970s to 2007 signalled the AOI’s growing overvaluation. During the 1970s, the ten-year PE ratio averaged 11.4; during the 1980s, 16.1; during the 1990s, 19.3; from 2000 to mid-2007, 22.1; and in mid-2007, just before the boom peaked, it stood at 26.5 – almost twice as large as its one-year counterpart. In December 2008, the ten-year PE had fallen to 16.3 – a considerable descent, to be sure, and to 15-year low; but not to a level that by the standards of the 1970s or 1980s would be regarded as cheap.<sup>10</sup>

**Implication #3:** Something else should (but in 2008-2009 apparently doesn’t) trouble the Australian crowd. Recessions usually cause bear markets; and during such bear markets, the market’s one-year PE ratio typically falls. It does so because recessions normally crush earnings, and because the prices of stocks are generally more volatile than their earnings. Recall from Table 1 that, next only to the today’s bear market, the recession of the 1970s

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regained their pre-crash highs within the next year, despite the index still being well down. The same applies today. Cheap-looking garbage is still garbage. Buy quality and you will get returns.”

<sup>10</sup> The implications of the American data in Figure 3 are rather grim. By the standards of 2000-2007 (when its one-year PE ratio averaged 24.9), and by the standards of the 1990s (when it averaged 21.6) the S&P 500 Index was very expensive in December 2008 (although it averaged 20.8 during the year, by December its one-year PE head reached 33.2). Further, by the standards of the 1980s (when its one-year PE averaged 12.0) and by the standards of the 1970s (9.4) American stocks were very dear in December 2008. Similarly, the ten-year PE ratio’s trajectory over the decades indicates growing overvaluation relative to venerable standards of valuation. During the 1970s, the ten-year PE averaged 10.2; during the 1980s, 11.5; during the 1990s, 25.3; from 2000 to mid-2007, 27.8.

produced one of the deepest and most extended funks in Australian financial history. And the recession and bear of the early 1980s was no picnic, either. During those years, the market's one-year PE ratio fell to upper-single digits. If the present ructions in credit markets are indeed the most severe since the Great Depression, and if they have produced (or will shortly produce) the most severe recession since the 1930s, then *even assuming that corporate earnings do not decrease* the AOI could easily fall one-third from its average of 2008.

To see this, note that in December 2008 the AOI averaged 3,523 and All Ords Ltd earned an average of \$416.98, yielding a one-year PE ratio of 8.5. Let's assume that a severe recession occurs and pushes the PE ratio to 7.5, and (very charitably but highly unrealistically) that the AOI's earnings remain constant. If so, then \$416.98 times 7.5 implies an AOI of 3,127 – a level almost 38% below its average of 2008, and to which it actually fell in March 2009. Similarly, a recession like those of the 1970s and 1980s might well reduce the 10-year PE ratio from its current 16.3 to ca. 11-12. Over the past decade, which encompasses what is perhaps the greatest earnings bubble in Australian history (see the next section for details), the earnings of the AOI have averaged \$244.65, and a ten-year multiple of (say) 11.5 implies an AOI of 2,813. Of course, earnings fall – often savagely – during a recession. Accordingly, he who posited late in 2008 and early in 2009 that the AOI had reached or was close to a “bottom” was expressing a heartfelt desire rather than a reasoned conclusion.

### **Do Corporate Earnings Indefinitely Grow? Or Do They Ebb and Flow?**

Let's now focus upon the earnings of the companies comprising the All Ordinaries Index (Figure 4) and, for purposes of comparison, of the firms comprising the S&P 500 (Figure 5). “All Ordinaries Ltd” earned \$33.97 per share in 1974 and \$458.14 in 2008. What about the intervening years? “Raw” (that is, unadjusted for CPI) earnings grew steadily during the 1970s,<sup>11</sup> fell 23% during the recession of the early 1980s (from \$66.03 in 1980 to \$50.78 in 1982), resumed their rise – indeed, rose very rapidly – and reached a peak of \$126.06 per share in 1989. Earnings then contracted sharply (by 53%) during the recession of the early 1990s (to \$59.79 in 1993, returning to the level prevailing between 1979 and 1983). They subsequently recovered this loss and resumed their steady rise during the remainder of the 1990s and into the early years of the new century. Finally, earnings skyrocketed from April 2003 (\$187.15) until September of 2008 (\$489.22). Since then, they have fallen steeply (to ca. \$365 in late February 2009).<sup>12</sup>

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<sup>11</sup> During those years, the CPI raged so severely that earnings hardly fell in nominal terms (i.e., from \$33.97 in 1974 to \$31.36 in 1975).

The projected earnings in Figures 4-5 ignore the explosion of profits after 2003, and answer the question: “if the trend from 1974 to 2003 once again prevailed, what level of earnings could we expect during the next five years?” In effect, I have drawn a best-fitting (“regression”) line through the earnings observed from 1974 to 2003, and then extrapolated this line into the next five years. If this long-term trend reasserts itself, then the earnings of All Ordinaries Ltd will fall by more than half (i.e., by 55%) from the average level attained in 2008. As the recession of the early 1990s reminds us, such a decrease has a relatively recent precedent. Further, if we are indeed in the midst of the worst crisis since the 1930s and a severe recession beckons, then such a sharp drop of earnings is hardly outside the bounds of possibility.<sup>13</sup>

**Figure 4: The All Ordinaries’ Earnings, 1974-2008 –  
See If You Can Spot the Bubble**

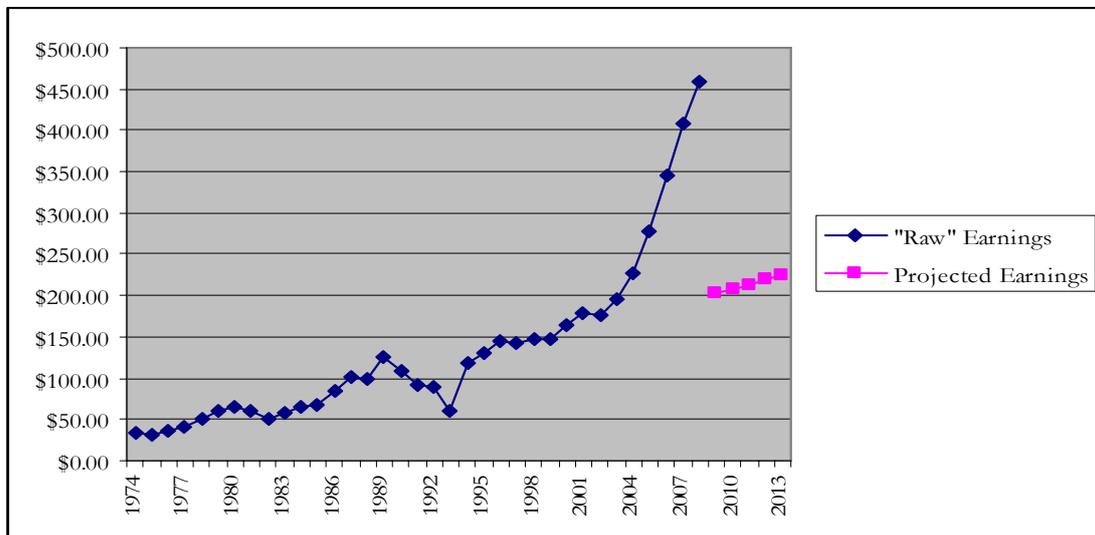


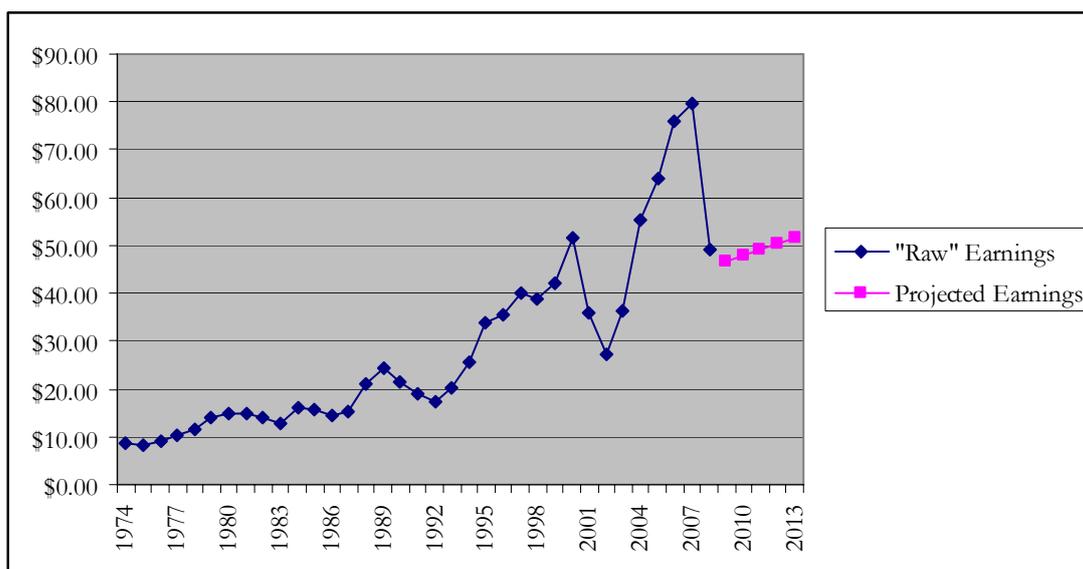
Figure 4 tells us five things about the “raw” earnings of the AOI. First, as a rule they rise: their trend over the decades, in other words, has an upward slope. Second, over shorter periods they can rise much more rapidly than – and thus rise considerably above – the overall trend. Third, what goes up eventually comes down. Yes, earnings typically rise year after year; but they can also fall

<sup>12</sup> In the fourth quarter of 2008, the S&P 500’s earnings were negative, and more than 400 of its 500 firms recorded losses. For six quarters, the earnings of S&P 500 had declined, and the sixth culminated – to my knowledge, for the first time since 1871 – in an actual loss.

<sup>13</sup> On 27 February 2009, Citigroup’s “global equities strategist,” Robert Buckland, broke ranks with the crowd. Placed inconspicuously within a 46-page analysis was an expectation derived from previous recessions in Australia and elsewhere – namely that corporate profitability in this country “would halve from peak to trough.” The peak of corporate profitability occurred in 2007, he said (for entities listed on the ASX it peaked in 2008), and estimated that the trough would occur in 2010. “We are probably down about 20% so far, so we’ve got a lot further to go,” he told ABC Television’s *Inside Business* on 1 March.

sharply for several years in succession and thereby retrace much or all of their previous gain. Earnings, in other words, can also fall below their long-term trend. (What causes earnings to plunge below trend? More than anything, recessions do.) Fourth, Phoenix rises from the ashes. True, recessions raze earnings. But the firestorm eventually passes, green shoots appear and thicken, and earnings resume their upward march. The fifth point, then, is that over the decades “raw” earnings don’t grow without interruption: they ebb and flow at various speeds along a modestly upward long-term trajectory.

**Figure 5: The S&P 500’s Earnings, 1974-2008 –  
A Bubble That’s Burst?**



Even when unadjusted for CPI, the AOI’s earnings regularly stagnate and occasionally soar; on average, they rise modestly over time. They doubled between 1974 and 1985 (when they reached \$67.56). But from 1986, when they zoomed to \$84.19, they took 15 years to double again (to \$178.41 in 2001). The explosion of earnings from 2003 to 2007 (when they increased 2.6-fold) is unprecedented, but not by a country mile. Most notably, earnings doubled during the five years from 1982 to 1987. An examination of the historical record thus shows that earnings can double within a few years; it also shows that earnings can halve within a few years.

Since 1974, then, the AOI’s unadjusted (for CPI) earnings have risen at a compound rate of ca. 6% per year; further, they have varied around this trend line but regressed reliably back towards it. That is, the more it is that earnings have risen above the trend, the more sharply they have subsequently decreased towards it. The phrase “the higher they rise the harder they fall” summarises this mean-regressing tendency. It suggests that during the next few years – and regardless of whether there’s a recession – the AOI’s earnings will return to their long-term trend.

**Implication #4:** Can we say anything more precise than this? For the sake of simplicity but quite unrealistically, let's assume that during 2009 the earnings of All Ordinaries Ltd regress to the long-term trend of \$203.39. Let us also assume, perhaps as a consequence of a severe recession, that the Index's one-year PE ratio falls to 7.5. If so, then the All Ordinaries will fall to 1,680 – a decrease of 52% from the level prevailing in December 2008. Let's also assume that earnings remain exactly “on trend” through 2013, and thus increase to \$223.99. Finally, assume that by 2013 the Ords' average one-year PE ratio of 13.8 reasserts itself. If so, then in 2013 the Index will rise to 3,089.82.<sup>14</sup>

**Implication #5:** Again, assume that during 2009 the earnings of All Ordinaries Ltd regress to the trend of \$203.39, that these earnings remain exactly “on trend” through 2013. If so, then the average earnings of the AOI for 2004-2013 are \$278.50. Finally, assume that the average ten-year PE ratio that prevailed in the 1970s and 1980s (i.e., 15.1) reasserts itself. If so, then in 2013 the Index will rise to 4,205.<sup>15,16</sup>

### Using Dividends to Value the All Ordinaries and S&P 500

An analysis of the dividends paid by the companies comprising the All Ordinaries and S&P 500 indexes can also help us to estimate their value. Figure 6 shows that “All Ordinaries Ltd” paid a dividend of \$16.89 per share in 1974 and \$241.20 in 2008. “Raw” (that is, unadjusted for CPI) dividends grew steadily during the 1970s (the only exception is a decrease from \$17.24 in 1975 to \$16.42 in 1976), fell 12% during the recession of the early 1980s (from

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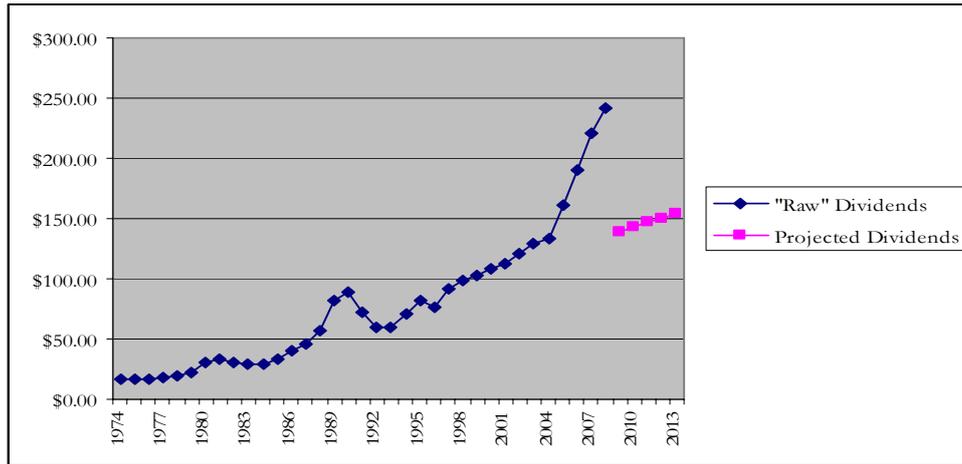
<sup>14</sup> Similarly, let's assume (much more realistically) that during 2009 the earnings of the S&P 500 regress to the long-term (1974-2003) trend of \$46.81. Let us also assume, perhaps as a consequence of an exceptionally severe recession, that its one-year PE ratio falls to 7.5. If so, then the S&P 500 will collapse to 351 – a decrease of 60% from the level prevailing in December 2008. Let's also assume that earnings remain exactly “on trend” through 2013, and thus increase to \$51.57. Finally, let's assume that by 2013 the Index's average (for the period 1974-1989) one-year PE ratio of 10.7 re-asserts itself. If so, then in 2013 the Index will rise to 551. If we assume that the average one-year PE for the entire period 1974-2008 (i.e., 17.6) will prevail, then the Index will rise to 907.

<sup>15</sup> Implication #5 is less dour than #4 primarily because the first five of the ten years used to calculate the 10-year average earnings occurred during the Earnings Bubble. Arguably, because the 10-year average of earnings is inflated it produces relatively rosy results.

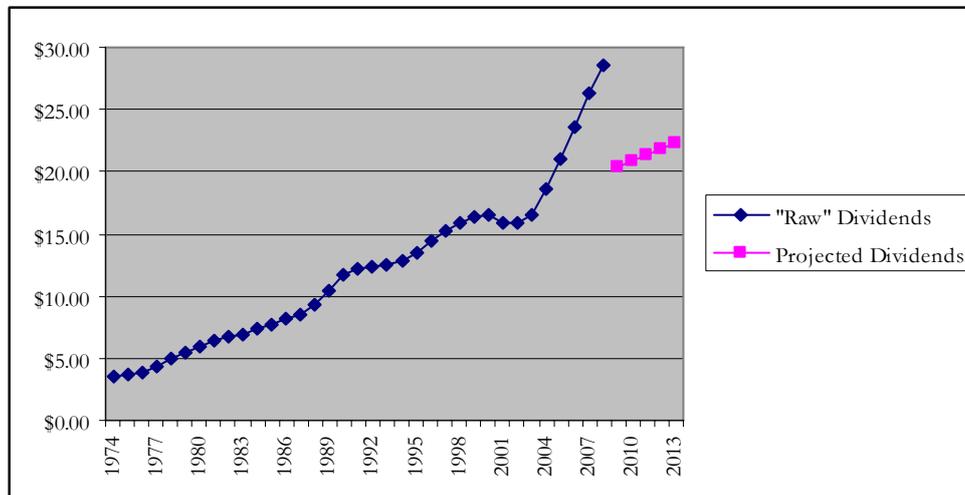
<sup>16</sup> In the U.S., the 10-year PE ratio produces equally dispiriting results than the one-year ratio. Again, assume that during 2009 the earnings of the S&P 500 Index regress to the trend of \$46.81, that these earnings remain exactly “on trend” through 2013, and thus increase to \$51.57. If so, then the Index's average earnings for 2004-2013 are \$57.00. Finally, assume that the average ten-year PE ratio prevailing during the 1970s and 1980s (10.85) reasserts itself. If so, then in 2013 the Index will rise to 619.

\$32.90 in 1981 to \$28.88 in 1983), resumed their rise – indeed, rose at a rapid pace – and reached a peak of \$89.06 per share in 1990. Dividends then shrunk 33% during the recession of the early 1990s (to \$59.66 in 1993). They subsequently (1997) recovered this loss and resumed their steady rise. And like earnings, so too dividends: they rocketed upwards after 2003. Figure 7, which presents analogous data for the S&P 500, tells a similar story.

**Figure 6: The All Ordinaries Index's Dividends, 1974-2008 – Is There a Bubble Here, Too?**



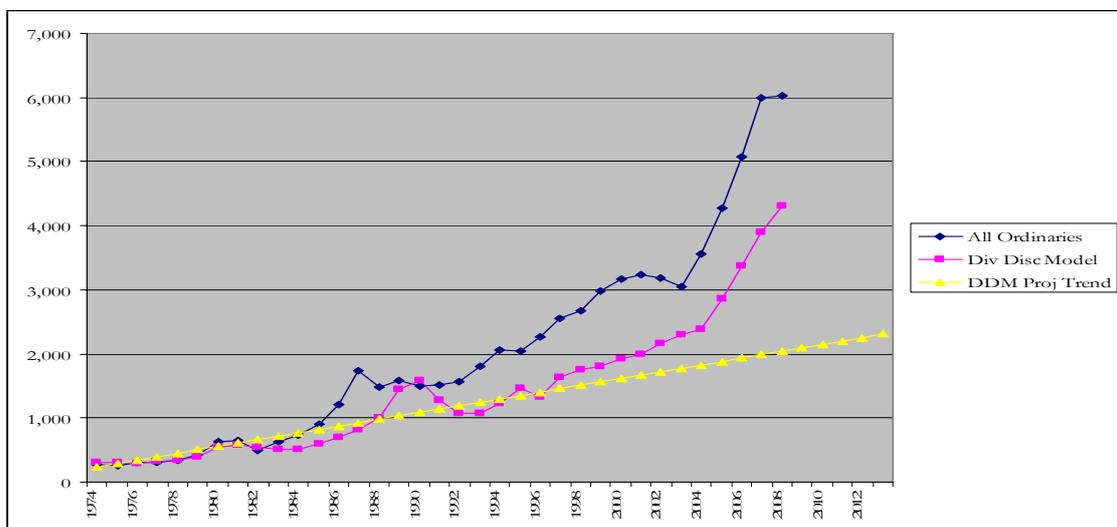
**Figure 7: The S&P 500's Dividends, 1974-2008**



The projections in Figures 6-7 ignore the explosion of dividends from 2004, and answer the question: “if the trend from 1974 to 2003 once again prevailed, what level of dividends could we expect during the next five years?” I have drawn a best-fitting (“regression”) line through the dividends from 1974 to 2003 and then extrapolated it into the future. If this long-term trend reasserts itself, then the AOI’s dividends will fall by 42% from the level attained in 2008, and those paid by the S&P 500 will decrease by 29%. As Australia’s recession of the early 1990s reminds us, such a decrease has a relatively recent precedent.

The value of a stock (or market index) approximates the sum of the dividends that the corresponding firm (or the firms comprising the index) will generate over time, adjusted for certain variables (which are subject to constraints)<sup>17</sup> and discounted by some appropriate rate. Versions of the dividend discount model (DDM) have long served as a means of stock and stock market valuation. Ben Graham used one; so did Robert Shiller in *Irrational Exuberance* (Princeton University Press, 2<sup>nd</sup> ed., 2005). One of the simplest and most robust DDM, known as the “stable model” and the “[Gordon growth model](#),” values a firm or market that is assumed to grow indefinitely at some specified constant rate.

**Figure 8:  
The Fair Value of the All Ordinaries Index (1974-2013)  
Implied by a Gordon Growth Model**



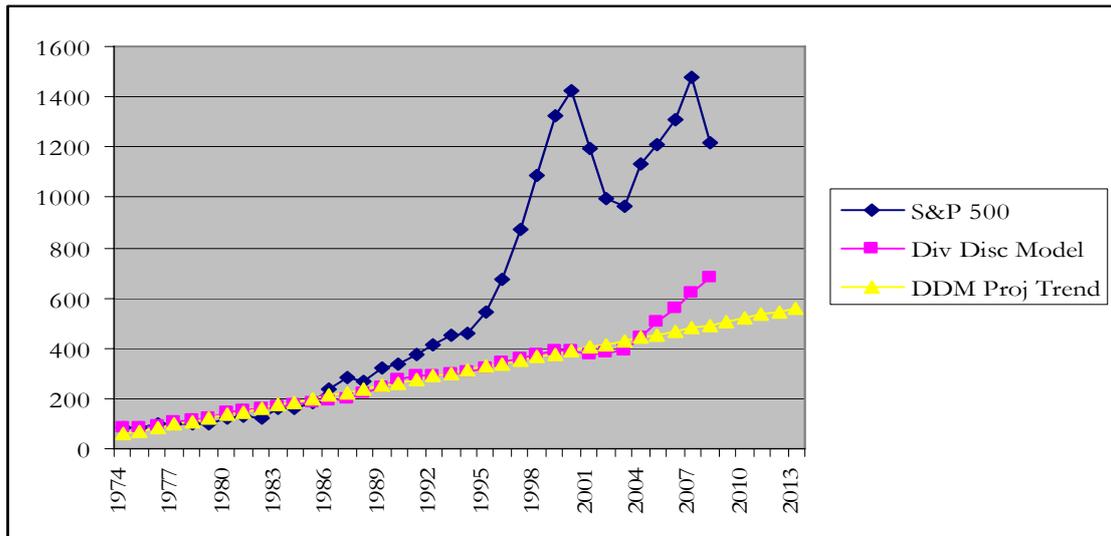
An analysis of the AOI since 1874 (for a summary, see [Leithner & Co.’s Objectives and Possible Returns](#)) shows that 6.5% per annum is a realistic rate of long-term growth; interestingly, an analysis of Shiller’s S&P 500 data from 1871 to 2008 shows that 6.5% is also an appropriate long-term rate in the U.S. The DDM also requires a discount rate (in effect, the investor’s required rate of return), and I have posited 12.5% for Australia and 11.5% for the U.S.<sup>18</sup> As a final input, the DDM requires a dividend payout ratio (that is, the dividend

<sup>17</sup> Two constraints are most important. First, the growth rate of the firm/market cannot exceed the required rate of return. If so, then the resulting valuation would be less than zero. Second, the growth rate of the firm/market cannot exceed the overall economy’s nominal rate of growth. If it did, then the valuation of the firm or market would eventually exceed that of the entire economy.

<sup>18</sup> Mainstream analysts usually ridicule this allegedly high rate. But the higher the discount rate the more conservative the valuation (for details, see [Leithner & Co.’s conception of risk and framework for risk management](#)). Further, to the dismay of the majority, this and the other assumptions produce valuations that correspond reasonably closely to reality at stock market “bottoms” – and highlight the extent of overvaluation during booms.

paid in a given year expressed as a percentage of that year's earnings). For the DDM, I have used the actual ratio prevailing in the given year; and for the projected trend of the DDM (which uses as its estimate of earnings that produced by the "best fitting line for 1974-2003) I have used the average dividend payout ratio for the entire period (59% for the AOI, 46% for the S&P 500).

**Figure 9:  
The Fair Value of the S&P 500 Index (1974-2013)  
Implied by a Gordon Growth Model**



The results of this analysis appear in Figures 8-9.<sup>19</sup> In both countries during the 1970s and the first half of the 1980s, the index and the "fair value" implied by the DDM closely approximated one another. During these years no "overvaluation" prevailed. Indeed, during the mid-1970s the indexes occasionally fell below the DDM, implying that stocks were "undervalued." That changed in the late 1980s-early 1990s. From then until the deflation of the Internet Bubble and the very mild recession of the early 2000s, which caused the AOI to crest and the S&P 500 to swoon, the value of the index raced well ahead of the DDM's valuation. This divergence was particularly marked in the U.S. Thanks to the explosion of earnings and dividends in 2004-2008, this gap between the index and the DDM's valuation narrowed sharply – mostly because the DDM increased dramatically. This convergence was most evident in Australia.

<sup>19</sup> Some say that a "stable model" DDM understates the value of a company or market. This is primarily because it ignores considerations such as the value of patents, brand names and other intangible assets. One view is that an estimate of the value of intangibles should be added to the result of a DDM calculation in order to arrive at a more appropriate valuation. Another view (with which I agree) is that, to the extent that these intangibles actually have value, they will generate earnings and hence dividends – whose valuation the DDM estimates.

**Implication #6:** Where do things stand today? That depends upon one's assumptions regarding earnings and dividends since 2004. If one rejects the contention that a bubble of earnings and dividends accompanied the boom, then the S&P 500, which fell below 700 in March 2009, has closed the gap with the DDM (680) such that it now offers "fair value." What if one agrees that a bubble accompanied the boom, that the bubble is bursting and that earnings and dividends will regress to their trend of 1974-2004? Then the DDM's projected trend is the more relevant measuring stick. In 2009, the trend stands at 506, which implies that the S&P must fall ca. 25% from its March 2009 low of 670 before it approximates "fair value."

Annelina Lobb ("Dow 5,000? A Bearish Possibility," *The Wall Street Journal*, 9 March) produces a similar estimate. "As earnings estimates are ratcheted down and hopes for a quick economic fix fade, the once-inconceivable notion of returning to Dow 5,000 or S&P 500 at 500 looks a little less far-fetched." She notes that at the trough of the bear market in 1974, the S&P had a "forward" PE ratio of 11.3; in the trough of 1982, it was 8.5. "Put a multiple of 10 with estimates of \$40 or \$50 a share [Robert Shiller's figures produce an average of \$49.30 during 2008] and the S&P comes out at 400 and 500."

So does Bloomberg ("Graham Shows S&P 500 Still Too High As Buffett Loses," 9 March). "Benjamin Graham, the father of value investing and mentor of Warren Buffett, would find most U.S. stocks expensive even after the Standard & Poor's 500 Index dropped 56% in 17 months. Graham measured equities against a decade of profits to sooth out distortions, a method that [in February-March 2009] shows the S&P 500 trading at 13.2 times earnings, according to data compiled by Yale University Professor Robert Shiller. At the bottom of the three worst recessions since 1929, the average ratio fell below 10. To reach that level, the S&P 500 would sink another 27%."<sup>20</sup>

In Australia, the prognosis is rather grimmer. Since mid-2007, politicians, analysts and journalists have offered a list of reasons why this country will be more or less insulated from the worst. Steadily since mid-2007, one reason after another has been removed from this list, and few now remain. Hence the phrase "things will get worse before they get better" is more apt here than in

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<sup>20</sup> The article adds "the S&P 500 will rise to 1,007 by [the end of 2008], according to the average of 11 equity strategists tracked by Bloomberg. The projection represents a rise of 47% from last week's closing price and an increase of the price-earnings ratio to 18.88 times operating profit, based on the strategists' average per-share earnings estimate." Annelina Lobb, too, reports that "Wall Street strategists ... [are] sticking to forecasts of a second-half rally. 'Analysts are just slashing numbers and people are trying to extrapolate that earnings plunge into Dante's Inferno,' Citigroup's chief U.S. equity strategist says. [He] is keeping a year-end target of 1,000 on the S&P."

most other countries. “Is Australia the Next Ireland?” shouted the cover of a report issued by Citigroup Global Markets on 6 March. Oz, it states, must be regarded “as one of the next countries to be badly affected by the financial [and economic] crisis, in the wake of Ireland, New Zealand, the UK, Iceland, the Baltic states, Russia, Japan and so on.”

**Implication #7:** If one rejects the contention that a bubble of earnings and dividends accompanied Australia’s boom, then the All Ordinaries Index, which hovered around 3,150 in March 2009, has fallen well below the valuation implied by the DDM (4,310). But what if a bubble of earnings and dividends accompanied the boom? In 2009, the trend stands at 2,094, which implies that the AOI must fall another one-third (from its March 2009 low of 3,150) before it approximates “fair value.”

### **The Bust: A Brief Aberration or a Regression to the Long-Term Mean?**

At the beginning of the newsletter, I quoted rather selectively from “expert” prophecies. In 2008, a large majority was bullish to a delusional degree, hadn’t a clue what was happening and either ignored or denied the storm before it struck. But not everybody was a Pollyanna.<sup>21</sup> Indeed, and particularly after the bankruptcy of Lehman Bros. in mid-September, one could easily compile a long list of “expert” Chicken Littles proclaiming that a revisit of the Great Depression was imminent. The mainstream’s rhetoric, which was unrealistically optimistic in the first half of 2008, became absurdly gloomy in the second. As a result, throughout the year virtually nobody’s words and deeds were sensibly (i.e., on the basis of logic and historical evidence) pessimistic. Few emphasised or even recognised the extremes of 2003-2007; and still fewer confessed that a recession would mean much lower earnings, dividends and AOI.<sup>22</sup> Instead, a

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<sup>21</sup> Particularly notable were Stephen Ellis’ “Greenback” columns in *The Australian*. In “Reality Catches up with Investors Silly Enough to Believe the Cheerleaders” (3 July 2008), he plainly spoke the blunt truth. “Any investor who has been surprised by the latest crumbling of confidence and prices on Wall Street is a fool.” Ellis rightly showed how most American – and by implication, Australian – investors “have been wildly over-optimistic in their assessment of the outlook,” and how the “fervor to declare ‘the worst is over’ led by the chieftains of the very financial institutions that have so far lost the most in the downturn” was simply risible. Does his refusal to toe the conventional line explain why he and his column have disappeared? See also [Cold Reality of Share Prices](#) (3 February 2008).

<sup>22</sup> Alan Kohler is an exception. On 26 November, he wrote “Last week I sketched out a mathematical scenario in which the market could fall another 40% [from its current 3,650 to 2,190]. The depth of the likely recession in Europe and America, the unfolding problems in China and the extent of Australia’s house-hold indebtedness mean that something like this may not be just a mathematical scenario. In the event of a serious recession in Australia, with 10% unemployment and a big fall in retail sales, many stocks ... will suffer

determination to deny the true underlying cause and long-term consequences of the bust, obsess about surface symptoms and demand economically illiterate “stimulus” and “bailouts” pervaded the mainstream.

The American satirical publication *The Onion* (“the world’s most authoritative chronicle of fake news,” whose motto is “Tu Stultus Es”) brilliantly ridiculed this strident denial of reality (see [Recession-Plagued Nation Demands New Bubble to Invest In](#), 14 July 2008). This denial continued into 2009. A good example is [Stock Markets: When Will the Bull Return?](#) (*Business Week*, 5 March). The present, it alleges, is merely a “bear scenario” that will run its course. Once it does, the normal state of affairs – namely a bull market – will return. Investors should thus expect “... two more years of bouncing around and then another six or so before the Dow is back above 14,000.” In other words, conventional “experts” *still believe* that the events since mid-2007 are short-term aberrations, and that the boom of the past decade is the long-term norm. But what if regression to the mean takes another form – namely the permanent purging of the excesses of the booms since the 1990s, and a return to the benchmarks of valuation that prevailed during the recession-plagued 1970s and 1980s? Realistic pessimism is a far cry from despondent babble about another Depression; but it also dismisses any expectation of a smart return to the artificial and damaging booms of the late-1990s and mid-2000s.

### **So What’s the “Fair Value” of the All Ordinaries Index?**

If we capitalise the AOI’s earnings, then our estimate of fair value depends upon its level of earnings and the multiple (the inverse of the yield) at which we capitalise them. Table 2 posits a “bullish” assumption (namely that earnings don’t fall from their March level of \$365), a “mid-range” one (that they fall to a point mid-way between their current level and the long-term trend of \$203) and a “bearish” one (i.e., that they fall to their long-term trend). Note that I am ignoring the properly bearish possibility – which often becomes a reality during recessions – that earnings fall below their long-term trend. Regarding the earnings multiple, Table 2 posits a “bullish” assumption (that it doubles from its current level to 15.1 times), a “mid-range” one (that it rises to 10.1) and a “bearish” one (i.e., that it falls modestly to 7.5).

These two sets of assumptions yield nine estimates of the AOI’s “fair value.” If earnings fall to their long-term trend and bearish multiple emerges, then the All Ords’ fair value is 1,688 – roughly half the level of its low in March 2009. If earnings remain constant and the “bullish” multiple suddenly prevails, then fair value is 5,512 – a modest 67% above the March trough. Mid-range assumptions with respect to both earnings and the multiple generate an estimate of 3,127 – just below the March low.

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more than they already have. This is far from a certainty, but it is [a bigger] risk than the politicians and the others who are trying to ‘talk the economy up’ are telling you.”

Table 2 also shows three estimates derived from the dividend discount model (DDM). Underlying each estimate is the AOI's current dividend payout ratio (53%), an indefinite growth rate of 6.5% and a discount rate of 12.5%. The mid-range of earnings generates an estimate that's 10% below the Index's March trough. The bullish assumption implies that, at its March low, the Index was undervalued by ca. 6%, and the bearish assumption implies that was overvalued by ca. one-third.

**Table 2: A Summary of Our Results:  
The "Fair Value" of the AOI in 2009**

	Bearish Multiple (7.5)	Mid-Range Multiple (10.6)	Bullish Multiple (15.1)	Div Discount Model	Mean
Bullish Earnings (i.e., Don't Fall)	2,738	3,869	5,512	3,512	3,908
Mid-Range Earnings	2,213	3,127	4,455	2,838	3,158
Bearish Earnings (i.e., Fall to Long-Term Trend)	1,688	2,385	3,398	2,165	2,409
Mean	2,213	3,127	4,455	2,838	3,158

Which assumptions to choose? I believe that the AOI's earnings formed a "bubble" in 2003-2008, and the higher they rise the harder they fall. Moreover, Australia is on the brink of – or has already entered – a nasty recession. From the middle of 2007 until the end of 2008, albeit with waning conviction, the mainstream denied that a recession of any description was possible; and in 2009, the expectation is that the funk here will be milder than in America, Britain, etc. What might finally open people's eyes? The recognition that mining and banking are cyclical industries might do the trick. On 11 March, for example, Goldman Sachs JBWere revised its forecasts for BHP Billiton and Rio Tinto. In May of 2008, it predicted that in 2009-2010 BHP would earn \$US28.0 billion; in March 2009, it slashed this estimate by 75% to \$US7.4 billion. Last year, GSJBW predicted that in 2009 Rio would earn \$US17.9 billion; and in March it reduced this estimate by 77% to \$US3.9 billion.

Further, the belated recognition that Aussie residential real estate is among the Western world's dearest – and that these prices, too, will regress back to their historical mean – will turn a few heads and furrow a few brows. In the words of *The Sydney Morning Herald* ([First-Home Buyers in the Eye of a Storm](#), 18 March), "the Australian housing market is facing the prospect of a 'perfect storm' of financial pressures – including high mortgage debt, overvalued homes and rising unemployment – in which prices could eventually fall by as much as 30 per cent, investors have been warned ... There is an increasing possibility of a major housing bust in Australia." It's happened in the U.S., and is occurring in the Old Country, so show me the reliable seer – the RBA

doesn't qualify! – who says it can't happen here (see also [Australian Housing Market Holds Sub-prime Danger](#), *The Sunday Telegraph*, 22 March).

If a severe and extended recession is in the cards, then people's estimates of the AOI's fair value will gradually be dragged, kicking and screaming and amidst much whining, towards the "bearish" cells of Table 2. You say that these levels are intolerably low? Then accept Warren Buffett's challenge. On 22 November 1999 (when the S&P 500 stood at 1,391 and the Dow Jones Industrial Average at 9,116 and the best and the brightest could – thanks to the Internet – see naught but financial blue sky and economic sunshine for years into the future) he told *Fortune* Magazine "Maybe you'd like to argue a different case. Fair enough. But give me your assumptions. If you think the American public is going to make 12% a year in stocks, I think you have to say, for example, "Well, that's because I expect GDP to grow at 10% a year, dividends to add two percentage points to returns, and interest rates to stay at a constant level." Or you've got to rearrange these key variables in some other manner. [But] the Tinker Bell approach – clap if you believe – just won't cut it."

Armed with our reasoning and data, and keeping in mind that their implications are hardly credible predictions, we can answer our questions:

1. Has the All Ordinaries Index "hit bottom"?
2. What is its "fair value"?

I believe neither that it's hit bottom nor that it's close to a bottom. The course of its descent to – and the level of – its eventual nadir depend partly upon the extent to which the AOI's earnings fall; and that, in turn, hinges partly upon the severity of the recession. Earnings peaked in October 2008 at \$489, and by March 2009 had shrunk to \$365. If they revert to their long-term trend, then ca. 40% of this distance has been traversed. Of course, just as observations "overshoot" above a trend, they can also "undershoot" below it.

Given how we came to this pass, where Australia now stands, what the government is doing to us and what may lie before us, it's difficult to conclude that stocks are cheap and easy to believe that they remain dear. True, the AOI is less overvalued now than it was, but "less overvalued" is not the same as "undervalued." Accordingly, Leithner & Co.'s plans include the possibility that an environment marked by recession and stagflation (like the one that plagued the early 1970s to the mid-1980s) prevails during the next several years. In such a climate, the fair value of the All Ordinaries Index would be ca. 1,700-2,300. That implies a fall of ca. 70% from the Great Bubble's maximum and the harshest bear market in Australian history. Furthermore, taking 2,000 as the AOI's "bottom" and assuming a long-run growth rate of 7.5% per annum, ca. 17.5 years will pass before the Index returns to its Bubble maximum of ca. 6,850. If so, this will be the most fraught recovery in Australian history.

## When Will the Bear Market End?

“When you stop asking,” snapped the broker to the pestering client during the recession and bear market of the early 1970s (see James Grant, *The New York Times*, 1 March 2009). When would that ferocious bear return to his cave? Nobody knew, or could possibly know, to any reliable degree; and exactly the same point applies today. This broker, wiser than he realised, did not babble the windy non-answer that pervades today’s mainstream media: “Well,” he mercifully didn’t prattle, “the bear market will end when the Watergate crisis is resolved and the Vietnam war ends and Gough Whitlam is returned (or sacked, depending upon your politics) and the RBA imposes its will upon the CPI and businessmen regain their confidence.” This broker inadvertently confided the subtle and profound truth that a bear market tends to end when investors despairingly conclude that it never will (see also Russell Napier, *Anatomy of a Bear: Lessons from Wall Street’s Four Great Bottoms*, 2<sup>nd</sup> ed., Harriman House, 2005).

Hope sustains life and faith gains salvation, but delusions create and prolong recessions. Booms don’t just precede busts: they cause them. Modern booms, Leithner & Co. has recounted repeatedly for a decade, are the inevitable results of central banks’ policies of high inflation and the ensuing artificially low rates of interest and dangerously easy terms of credit. The boom countermands the true signals emitted in a free market, and spawns the myriad false indicators that provoke the bust (see also Peter Schiff, [My Visit to the Mises Institute](#); George Reisman, [Economic Recovery Requires Capital Accumulation, Not Government “Stimulus Packages”](#) and Thomas Woods, *Meltdown: A Free Market Look at Why the Stock Market Collapsed, the Economy Tanked, and Government Bailouts Will Make Things Worse*, Regnery, 2009).

During the Great Bubble, businesses, households and politicians overborrowed and overpaid. Now, during the bust, the mainstream insists – vehemently and with a straight face – that the cure for a financial and economic hangover is yet another blinder. *The Weekend Australian* (“After the Binge,” 29-30 November 2008) correctly noted the damage that binge drinking causes. Its harm is physical (e.g., liver disease), cognitive (memory loss and depression) and social (unemployment, financial strain and damage to family and other relationships). Alas, mainstream economists and journalists are utterly oblivious to the harm of binge economic policy. Babbling relentlessly about “stimulus,” they cheered until they were hoarse the RBA’s drastic reductions of the Overnight Cash Rate and Poindexter’s determination to “do whatever it takes” (except confess his economic illiteracy, repent and chart a sound financial course) to mitigate recession.

Like a crazed chemist who has only one type of snakeoil to prescribe, whatever the ailment, the RBA has only one policy – artificially low rates. This addictive drug rewards debtors (and borrowing), punishes savers (and saving) and shrinks the supply of real credit. And like a drug pusher on the street corner,

the Rudd gang (like the Howard regime that preceded it) peddles an hallucinatory substance – dependence upon the state – that invariably deranges those who consume it (see also [Socialism Leads to Stupidity](#) by Manuel Lora and Wilt Alstom, and [The Bubble That Must Burst](#) by Michael Rozeff).

But all the King's horses and all the King's men cannot put the borrow-and-spend Humpty Dumpty together again. They cannot borrow our way out of debt, or spend our way out of recession. Neither monetary nor fiscal central planning can avert this bust. Even the crazed left-wing Murdoch press has reluctantly acknowledged this reality.<sup>23</sup> For years, interventionists have posited a false choice: inflation *or* recession. Allegedly in order to keep recession at bay, central banks manufactured ever more inflation. That is, they increased the supply of money at a quickening pace and by a cumulatively vast magnitude: by the end of 2007, the supply of broad money in Australia was exploding at a rate of 20% per year (see also Michael Rozeff, [Global Money Inflation in the Late-Departed Boom](#), which confirms that in absolute terms and relative to most Western countries Oz has long been a bastion of inflation). Politicians and bureaucrats ignited the bonfire of inflation; inflation stoked the boom; the boom has caused the bust; and the government's ever more frenzied fiscal and monetary "stimulus" and hysterical "bailouts" are now fanning the flames and thereby intensifying and prolonging the bust.

The arsonists and their shells in the media (see in particular [Will the Stewart-Cramer Battle Be the Death of CNBC?](#) by Thomas Eddlem), watching the fire they have lit, are asking "how could this happen?" The answer, which cannot be overemphasised and which completely eludes them, is that the agents of the state are the sole creators of inflation – and thus the ultimate source of the dis-temper of our times. Their attempt in the early 2000s to banish recession has bequeathed to us the [Great Recession](#); and their manic attempt to mitigate the recession is now spawning ever more destructive policies (see, for example, [Printing Money: the Zimbabwean Solution](#) by Eamonn Butler and [The Weimar Way](#) by Pat Buchanan). The results of the state's meddling with money, capital, labour and land are now clear to anybody who'll open his eyes: rising inflation *and* deepening recession *and* a bear market whose bottom we've not yet seen.

*Chris Leithner*

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<sup>23</sup> "The Rudd Government's valiant bid to quarantine Australia from the global recession has failed," *The Weekend Australian* wailed on 6-7 March. "The domestic policy sandbags – the pre-Christmas budget stimulus, the rapid interest rate cuts, the bank guarantees and the lower Australian dollar – have not been enough to stop Australia from being swept into recession ... The biggest global policy stimulus in memory has failed to contain the crisis, sparking a new round of share market falls." Clearly, the truth that no amount of fiscal and interest "stimulus" can avert recession, and that "stimulus" is a poison that makes a bad situation even worse, remains as alien to them as the dark side of the moon.