November 2021 Market Commentary

Against the wind
We were runnin' against the wind
We were young and strong, we were runnin'
Against the wind
Wish I didn't know now what I didn't know then

https://www.youtube.com/watch?v=2vRsEC65NTA

Against The Wind by Bob Seger

Last weekend I decided to head downtown to ride the bike trails that run along the rivers. As I pedaled along, I looked out at the water, which was being whipped into white caps, and thought to myself, "Wow, it's pretty windy out there."

About halfway through my ride, I turned around to head back downstream, and I hit a wall of wind. Even though I quickly downshifted it felt like I was hardly moving forward, my pace was at least cut in half. And I laughed, "It really is windy out here."

When the wind was at my back, it felt like a gentle helping hand, yeah it was there but I was doing most of the work. But when it was blowing against my face, I couldn't believe that I'd been so foolish.

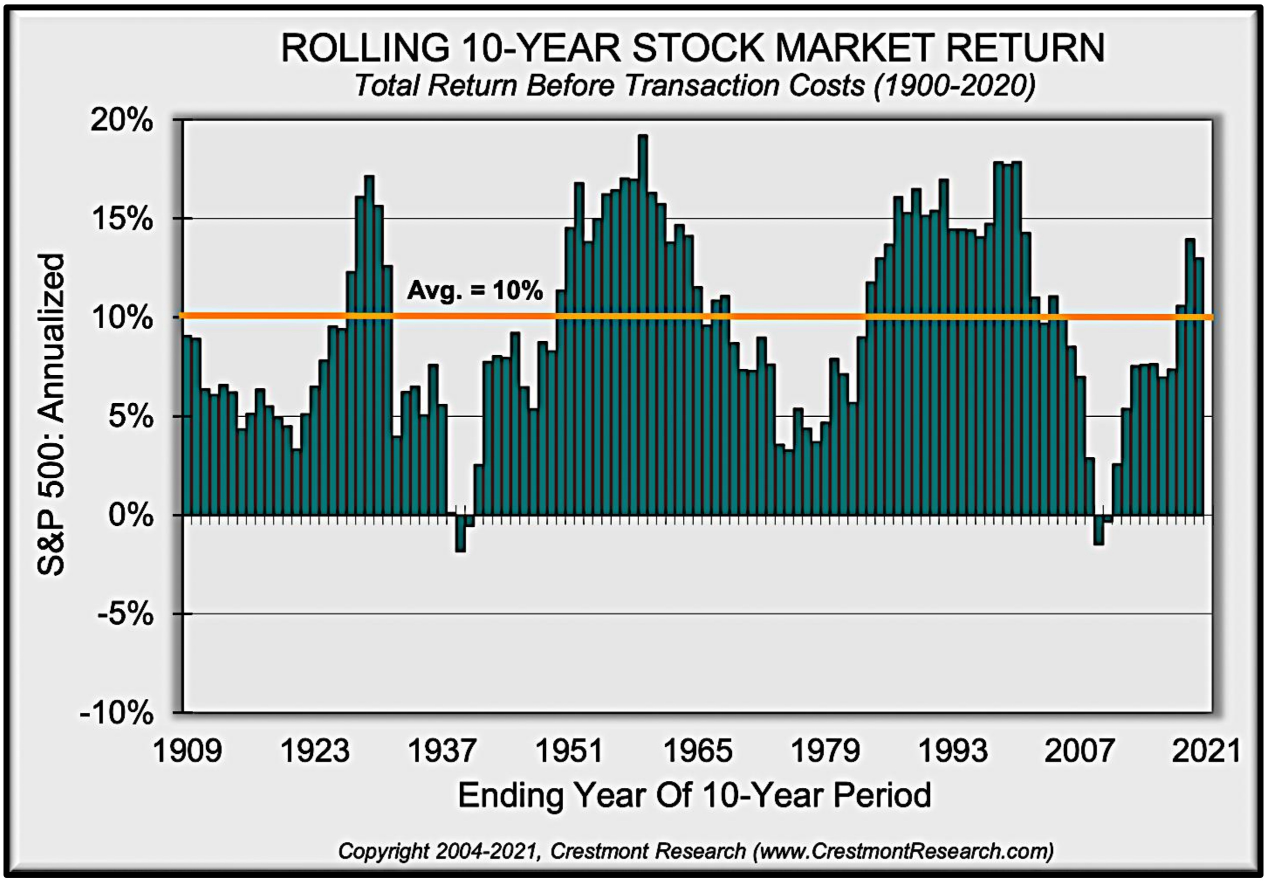
That's what Tom Gilovich, a psychologist at Cornell University, calls the "headwinds/tailwinds asymmetry. He says, "Like headwinds, obstacles are "in our face," reminding us of their existence, because we have to attend to them in order to overcome them. Tailwinds on the other hand, are like many of our benefits and privileges, they are easy to lose sight of because we typically don't have to attend to them. We just profit from them."

This very human condition; ignoring how helpful the tailwinds have been, and lamenting the many headwinds we have to contend with, is also present when we are investing.

Over the last ten years we have been investing with a howling wind at our backs, with the S&P 500 rising at a 16.50% annualized pace.

This is truly amazing when you consider the political circus, and the ongoing global pandemic we've had to endure. Like riding a bike with a tailwind, it's easy to be lulled into a state of complacency thinking that this great investing success is due to our efforts or intelligence. When in fact it probably has more than a little to do with the Fed's zero interest rate policy, quantitative easing, and massive injections of fiscal stimulus.

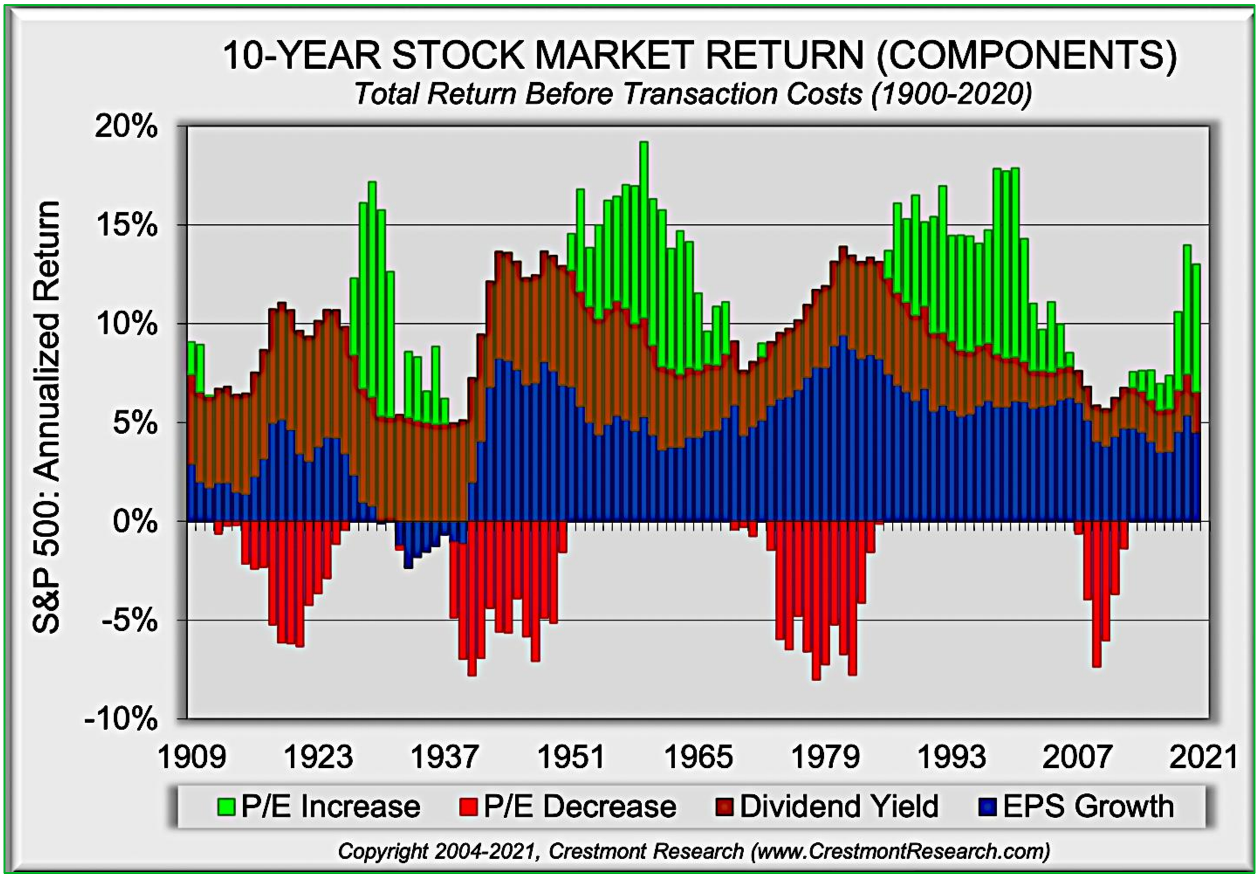
The graphic below shows just how spectacular our current 16.5% ten-year annualized return is compared to all rolling ten-year periods over the last 120 years. Over 120 years there have only been 19 ten-year periods where the returns on stocks were greater than 15% (20 when we include today). Also note that the current 16.5% is not shown on this graph since it ends December 2020.



Of course, many of these time periods are very different from each other and from today, but they all have the same underlying components of return; Earnings Growth, Dividend Yield, and Change in Price-to-Earnings.

The Change in Price-to-Earnings is simply what we are willing to pay for that earnings growth and dividend yield. I also like to call this PE Psychology-to-Earnings, because it reflects how bullish or bearish investors are feeling. When investors are complacent and optimistic, the wind is at their backs, PE's expand. And when investors are fearful and pessimistic, the wind is pounding them in the face, PE's contract.

The chart below shows the same rolling ten-year periods deconstructed to show you where your total return came from.



I've always found this graphic to be very illuminating. Earnings growth (the blue bars) has generally been positive outside of the negative years during the Great Depression. In fact, earnings growth tends to track very closely with nominal GDP growth and has averaged about 5.2% over time. A little closer to 3.5%-4% of late.

Dividends accounted for about 4.3% of total returns over these 120 years. Dividends were a huge contributor to returns a century ago, but have been a much smaller contributor as the Technology sector has grown in importance and weight. Today the dividend yield on the S&P 500 is only 1.23%.

PE Change, our headwinds and tailwinds, tend to balance out over the decades. Over these 120 years we've had a slight increase in PE that accounted for 0.6% of total return. You can clearly see that in those decades when annualized returns climbed above 15%, they were universally accompanied by expanding PE's. And vice versa, when returns fell to the low single digits or negative we had contracting PE's.

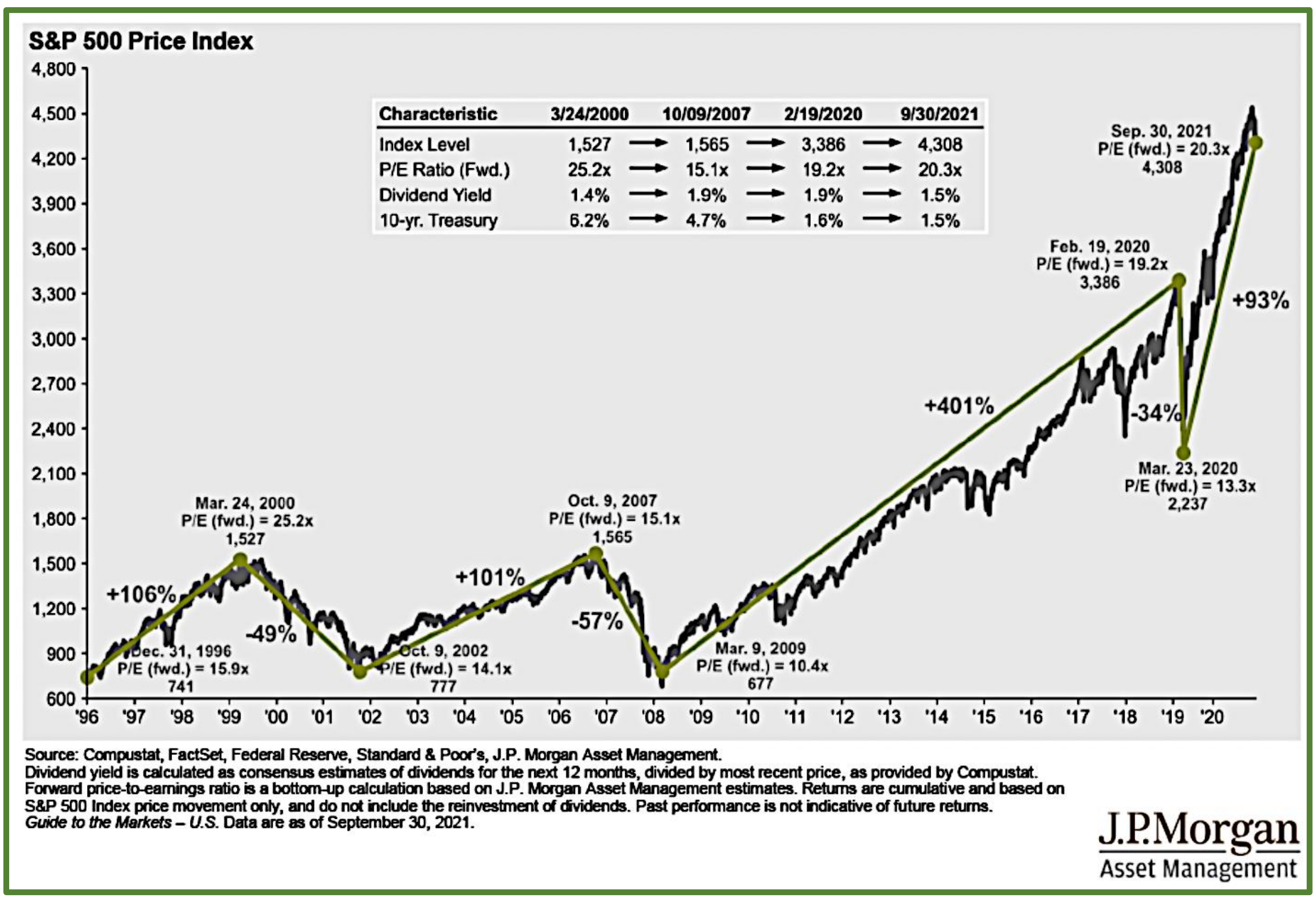
Here's how the historic averages worked:
Earnings Growth 5.2% + Dividend Yield 4.3% + Change in PE 0.6% = Total Return of 10.1%

So, here we are effortlessly riding along, thinking about how smart we are to be able to generate returns of over 15% for the last decade. When a little voice in the back of our heads asks, how long do you think this ride will last? Will the tailwinds turn to headwinds?

Let's look at the numbers. I'm going to give our economy and corporate America the benefit of the doubt, and say that we avoid a recession over the next decade and continue to generate earnings growth of about 5%.

The current dividend yield of 1.23% is a pretty solid number, and probably won't increase unless prices fall or there is a change in tax policy that lowers taxation of dividends (not likely).

That gets us to about 6%. The key question then becomes what happens to PE's, do they expand or contract?



The chart above shows our current PE of about 20.3x compared with the PE's from several recent peaks and troughs. While 20.3x isn't the record, it is only exceeded by the internet bubble peak of 25.2x in 2000. This is the tough part of forecasting, will investors pay more and more for that 6% earnings and dividend yield, or will something arise that will make them less optimistic? You see, if PE's just stay at their current level of 20.3x then the total return will fall from 16% to 6%. We actually need PE's to continue to expand for us to generate double digit returns. And if PE's contract back to a more normal 17 or 18x, well then, we get pretty negligible returns.

No doom or gloom here, just being cognizant of the fact that I'm not all that smart or strong, that I've been enjoying that strong tailwind, but sooner or later I'm going to be runnin' against the wind.

Against the wind
A little something against the wind
I found myself seeking shelter against the wind

As always, be careful out there.

Chris Wiles, CFA

Where Trust is Earned