

Leithner Letter No. 96-98

26 December 2007-26 February 2008

Let me summarise what I've been saying about the stock market: I think it's very hard to come up with a persuasive case that equities will over the next 17 years perform anything like – anything like – they've performed in the past 17. If I had to pick the most probable return, from appreciation and dividends combined, that investors in aggregate – repeat, aggregate – would earn in a world of constant interest rates, 2% [CPI], and those hurtful [brokerage and other transactions] costs, it would be 6%. If you strip out the [CPI] component from this nominal return, that's 4% in real terms. And if 4% is wrong, I believe that the percentage is just as likely to be less as more.

Now, 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 internally-consistent manner. But the Tinker Bell approach – clap if you believe – just won't cut it.

Carol Loomis
[Mr Buffett on the Stock Market](#)
(*Fortune*, 22 November 1999)

Of High P/Es, Low Yields, Raging Inflation and Overstretched Asset Prices

The end of one calendar year and the beginning of the next is an appropriate time to reflect upon the outgoing year's twists and turns, triumphs, trials and tribulations. It is also a good time to place these things into a broader context, consider their possible causes and consequences, learn one's lessons and set a course for the twelve months to come. Taking into consideration the year's financial, economic and other developments in Australia and the U.S. (and less directly in Britain, Canada, New Zealand), it seems to me that a focus upon the downside, what has gone awry and what can go wrong is presently far more sensible than the expectation of further upside and what will keep going right.

The more the prices of securities exceed cautious assessments of their values, the lower the rewards from owning those securities will subsequently tend to be. Today, the prices of most stocks, bonds and titles to real estate are, relative to their underpinnings' long-term averages, much too dear. Prices were already too high for my (and, it is vital to note, Mr Buffett's) liking before the very mild bear market of the early 2000s. Since then, of course, they have risen dramatically – and to what, by venerable and unfashionable standards, are dangerous levels. If so, then an ugly reckoning beckons. Clearly, the past five years have mocked this belief. But no matter: assuming that there's rarely anything new under the sun and that it's *not* different this time, the law that equilibrates prices and values will eventually reassert itself.

The prices of most securities are improbably high partly because interest rates remain artificially low; and rates are way too low because virtually everybody, not least the Commonwealth Government and RBA, misconceives inflation and its consequences. People almost invariably use the term “inflation” to refer to increases in the prices of raw materials, finished products and wages. They define inflation not in terms of what it *actually is* (as most British classical economists once did and all Austrian School economists still do), but in terms of *one of its possible consequences*. To the majority, inflation never denotes an increase in the supply of money (or, more precisely, money not backed by savings). They do not seem to know that under current arrangements, only the central bank can enlarge the monetary base; accordingly, only it can create inflation. The mainstream’s notion of inflation thus diverts attention from monetary interventionism, the great damage it causes and the central bank’s sole responsibility for it.

Because nobody ever asks them, Messrs Howard, Costello and Stevens never confess that inflation, properly defined, has long been the bedrock policy of the RBA and its political masters. Members of Australia’s political caste blame inflation’s eventual consequences upon everybody and everything except themselves, and (like firebugs who join the bushfire brigade) evade accountability for the conflagrations they inevitably create. Central banks’ relentless inflation debases the currency’s purchasing power. The routes to this destination are various, and its possible consequences include rising prices of raw materials, capital goods, consumer goods and services, wages and financial assets (or some combination of these things); overbearing and tyrannical government; the transfer of wealth from the disadvantaged towards the state’s cronies and mascots; and higher interest rates, malinvestment and ultimately recession.

Throughout the Howard-Costello Era, Australia has been – and today is more than ever – a high-inflation country. Money and credit are hard to define and thus to count, and so monetary figures are fuzzy. But their rough magnitudes and general trajectories are clear. The RBA has expanded the supply of broad money at ca. 9% per year since 1996, at 14% or more since 2005 and now (15% plus) at the fastest pace in thirty years. Oz is hardly alone: in Britain, the Eurozone, Japan and the U.S., inflation is galloping at more than 10% per year (although it may be decelerating in the U.S.), and at up to 20% in China. Not since the mid-1970s have the world’s major central bankers acted as recklessly as they are doing today. Yet virtually everybody assumes that the monetary settings that marked that turbulent era – and the economic disorder they caused – will never return. As a result, Australian securities are (relative to their earnings) at least twice as dear today as they were a generation ago. The problem is that destabilising monetary conditions have returned; the question is whether (and if so, when) sustained turmoil will follow.

The prices of most stocks are also prohibitively dear because most people believe that the explosion of corporate profitability since 2003 is genuine and permanent. They also assume that, even though its income net of CPI is barely growing, the average Australian household will continue to increase its borrowings by 5-10% per year (its debt-to-income ratio is presently 160%, the largest in Australian history and among the world’s highest) in order to keep pace with the neighbours. Can these diverging trends persist indefinitely?

Amazingly, given that it is a principal disseminator of mainstream boilerplate, *The Weekend Australian Financial Review* (12-13 August 2006) expressed my view perfectly: “So what can we conclude? Since early 2003, we’ve been ... in the middle of the first rally in what is a larger unfolding bear market – one in which equities could struggle in real terms

over the next decade.” Stocks in Western countries including Australia enjoyed a long-term (“secular”) bull market from the early 1980s until the late 1990s, and a secular bear market started at the turn of the century (see also *Unexpected Returns: Understanding Secular Stock Market Cycles*, Cypress House, 2005, by Ed Easterling). But governments and central banks have repeatedly spared no effort to disguise and postpone the recession that began to appear in 2001-2003. Their interventions, which have ignited epochal booms in commodity markets and what I suspect are cyclical bull markets for real estate and stocks, have muzzled the secular bear. But they have not solved problems bequeathed by the interventions of the past. They are simply accumulating troubles for the future. Accordingly, a severe recession is not a short-term hazard: it is a long-term necessity.

I believe, in short, the prices of most stocks, bonds and titles to real estate are excessive because the crowd’s knowledge of the past is partial, their perceptions of the present are inaccurate and their expectations about the future are unrealistic. People have forgotten – perhaps they never learnt – that earnings, interest rates and investment returns can *for a time* defy their historical “base rates.” When they do, enthusiasts invariably offer various reasons to explain why these deviations have appeared and will persist. Although they seldom use the phrase, the bulls always assert, in effect, that “it’s different this time.” Alas, it rarely if ever is: and as a result, earnings, interest rates and all the rest eventually revert to their long-term averages. Sometimes they do so suddenly and occasionally (and most notably during recessions) they overshoot these averages. Hence the hyper-low interest rates of the past decade imply higher rates during the next. Similarly, the recent spectacular growth of earnings implies a much more restrained pace of increases, and possibly decreases, in the future. Since 2003, sensational investment results have fallen almost effortlessly into Australians’ laps. The trouble is that – even without a recession, which should always but these days rarely figures in investors’ plans – above-average results imply sub-par (or worse) results during the next several years (see also [Golden Era or Gilded Age?](#) by Chris Leithner).

The Bulls Say the Market’s P/E Is Reasonable: Is It Really?

The All Ordinaries Index is an index – that is, a single number derived from an array of prices – of the stocks of major companies listed on the Australian Securities Exchange (which, before its merger with the Sydney Futures Exchange, was known as the Australian Stock Exchange). It has usually comprised 250 companies, and they have typically been selected on the basis of their size and the number of their shares that routinely trade on the ASX (as opposed to those owned by founding or controlling interests that do not trade them).

Figure 1 (p. 5) plots the All Ordinaries Index’s price-to-earnings ratio (also known as the “P/E” or “PE” ratio) on “one-year” and “ten-year” bases. Since 1974 (the earliest year for which I have been able to assemble valid and reliable data), the “one-year” ratio has averaged 13.9. To make sense of this number and 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 Index during a given year as if they were a single firm. If so, then 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 price-to-earnings ratio was $268 \div 33.97 = 7.9$.

“In former times,” noted Benjamin Graham in *The Intelligent Investor*, “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.” Another important advantage of this average level of earnings, Graham continued, was that it simplified the treatment of the various “one off” factors that regularly distort a single year’s earnings. This average, he concluded, “could give a really informing picture of the company’s past performance.” In Figure 1, the ten-year average PE for 1974 takes the All Ords’ “per share” earnings for each year from 1965 to 1974 (inclusive), computes their mean (\$24.83) and then divides the Index’s average level for 1974 (268) by this average level of earnings. Computed on this basis, the All Ords’ price-to-earnings ratio in 1974 was 10.8, and from 1974 to mid-2007 it has averaged 17.5.

The All Ords’ PE (one-year basis) implies that, in order to buy \$1 of this figurative company’s earnings during 1974, you would have spent an average of \$7.90. By the first quarter of 2007, the earnings of “All Ords Ltd” had swelled to \$407.56 and the Index averaged 5,803. Its PE was thus $5,803 \div 407.56 = 14.2$, which is slightly above its one-year average for the entire 33-year period. If in the March quarter of 2007 you wished to buy \$1 of the earnings of the figurative “All Ordinaries Ltd,” then you would have expended an average of \$14.20. 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.¹

The PE Ratio’s “Historical Average”

The bullish horde says it repeatedly, emphatically and sometimes triumphantly: stocks in this country are not expensive because the Australian market’s price-to-earnings ratio lies at or below its “historical average.”² Alas, when they invoke this average the bulls 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” basis using a (typically generous) estimate of next year’s earnings; and rarely, it seems, do they employ a PE ratio that uses a long-term average of earnings. Further, when they tout their “historical average” the bulls seldom designate the interval of history it covers; and virtually never do they justify it.

Figure 1 confirms the bulls’ mantra that, *by the standards of the 1990s*, when its one-year PE ratio averaged 17.0, All Ords Ltd is presently not expensive. But they seldom add that *by*

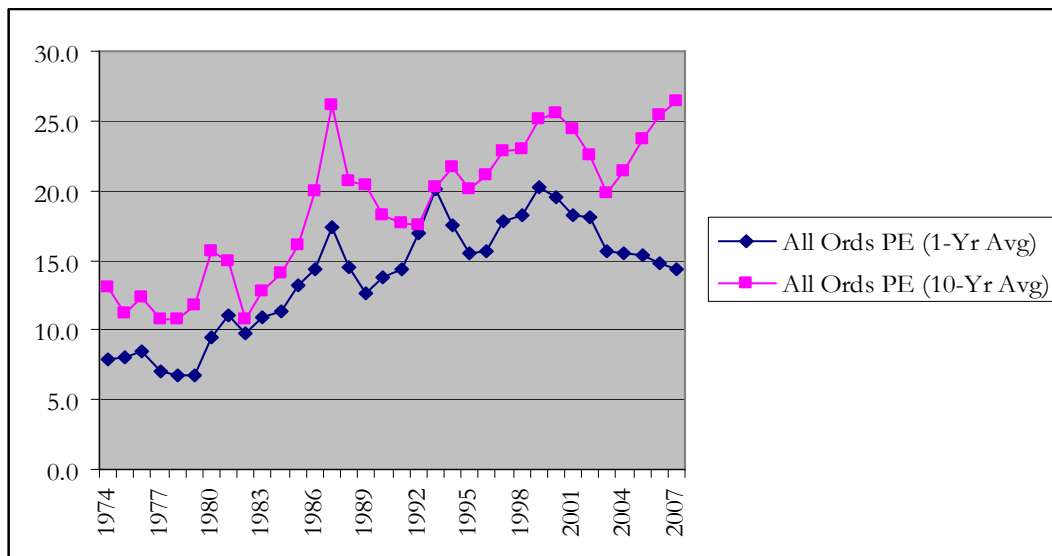
¹ [A Simple Calculation](#) (*Barron’s*, 31 May 2003) by Charlie Minter and Marty Weiner provides a concise overview of the various methods typically used to compute the price-to-earnings ratio.

² Or else they reckon, if it suits their purpose, that PEs are illusory or irrelevant. In an amusing mishmash of *non sequiturs* and sheer babble, *The Australian* (12 September) 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 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.”

the standards of the 1980s, when it averaged 12.5, today's market is not cheap; and by the standards of the 1970s, when it averaged 7.5, it is very expensive. Similarly, the ten-year PE ratio's trajectory over the decades flatly contradicts the bulls' current enthusiasm. Its inexorable rise since the 1970s, interrupted only occasionally and briefly, signals the All Ordinaries' growing overvaluation. During the 1970s, the ten-year PE ratio averaged 11.4; during the 1980s, 16.1; during the 1990s, 19.3; and since 2000, it has averaged 22.1. In mid-2007, it stood at 26.5 – almost twice as large as its one-year counterpart.

Something else should trouble the bulls. The ten-year measure has almost always (the nadirs of recessions seem to be the sole exceptions) exceeded its one-year counterpart. Why? The All Ords' 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 All Ords 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. Since 1974, however, this disparity has never been as great as it is now. Unlike its one-year counterpart, the ten-year ratio shows that during the past several the All Ordinaries has become much dearer. It has recouped the decrease it sustained in 2001-2003, and has now reached a level attained only once since 1974. Alas, few Australian bulls retain warm memories of 1987.

Figure 1: One Reason the Bulls Are Stampeded – and Another That Should Make Them Stop and Think



Equally and perhaps even more stretched valuations presently prevail in the U.S. [Robert Shiller](#), the author of *Irrational Exuberance* (Princeton University Press, 2nd ed., 2005), has analysed the earnings of American companies over the decades. Adjusting the data (which extend back to the late-19th century) in order to render them comparable over time, he finds that only in the late 1920s and late 1990s-early 2000s did the market's ten-year PE ratio exceed today's.

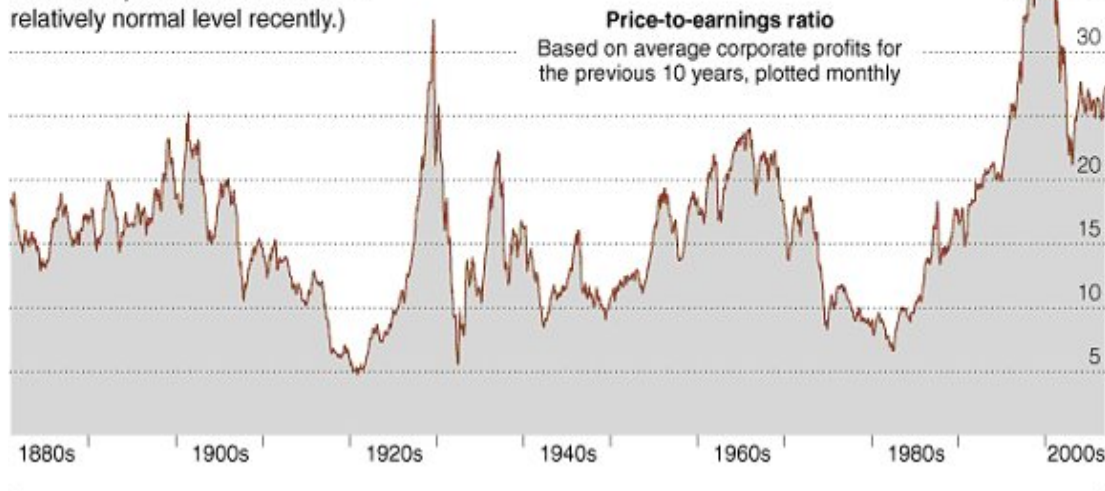
During the past ten years, corporate earnings in the U.S. have been unusually volatile: they rose very strongly in the mid-to-late-1990s, plummeted after the dot-com bubble burst and have soared since 2003. As a result, the recent past may provide a poor guide to the future. "It's not so much irrational exuberance as a lack of moorings," Shiller told

The Wall Street Journal (4 June). He became prominent on Wall Street by ignoring the crowd and dubbing the internet and telecoms (1995-2000) and housing (since the late-1990s) sectors as “bubbles” that would either pop or deflate. These days, he’s still dour. If the cyclical and other temporary factors that presently buoy corporate earnings recede – and his analysis shows that they always do – then “the stock market could be in trouble” (see the chart below). Ditto the housing market (see Shiller’s [Understanding Recent Trends in House Prices and Home Ownership](#), the chart on p. 7 and [Midsummer Meltdown: Prospects for the Stock and Housing Markets](#) by Dean Baker).

My suspicion, fortified with hefty dollops of cynicism, is that Australian bulls care about history only to the extent that it supports their enthusiastic predilections. And that means that they give a damn only about recent history. Hence their refrain: yes, on the basis of the All Ords’ one-year price-to-earnings ratio, stocks might have been dear during the late 1990s and early 2000s; but relative to those crazy days, today’s market isn’t overpriced. *The Australian* (11 July) is typical: “on forward [that is, estimates of next year’s] earnings, the S&P/ASX 200 [a cousin of the All Ordinaries] is trading at 15.5 times, which is spot on its historical average.” The graph accompanying this statement plotted data beginning in ... 1994! *The Weekend Australian* (28-29 July) added “valuations in most major share markets remain solidly below longer-term averages. In the US, the price-earnings ratio [of the S&P 500 Index] stands at 17.6, below its average of the last decade of 20.8. In Australia, the PE ratio of 15.2 is below the 15.5 long-term average. Savvy investors will recognise the current sell-off as a wonderful opportunity.”

A Different Way of Looking at Stock Prices

Relative to corporate earnings over the previous 10 years, stocks have been more expensive recently than at almost any other point in the last 130 years. The two exceptions are the great bull markets of the late 1920s and late 1990s. (By the more common definition of the price-to-earnings ratio, which compares stock prices to profits over the previous 12 months, stocks have been at a relatively normal level recently.)



Source: Robert J. Shiller

As the boosters see it, all is well because in the Lucky Country all simply *must* be well. Substantial losses in financial markets would, they imply, offend the rules of logic and the laws of nature. They would be unfair, would probably be unAustralian and might even be unconstitutional. Ditto the Old Country. According to *The Times* (2-3 June): “In March 2000, when stock market prices on Wall Street were last at today’s levels, a crash was a mathematical certainty ... [But] today, one can say with almost equal confidence that the conditions simply do not exist for a stock market collapse.”

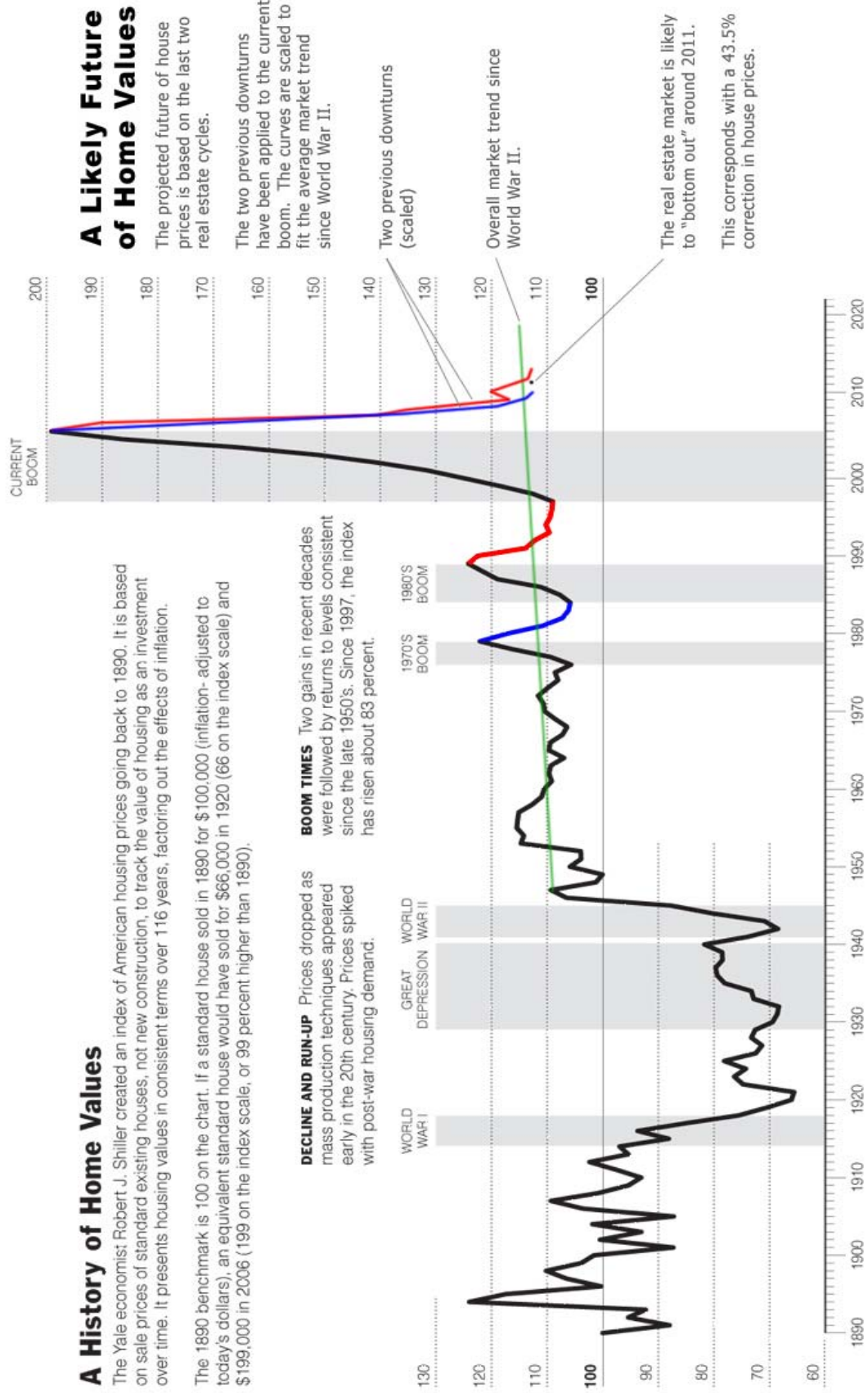
A History of Home Values

The Yale economist Robert J. Shiller created an index of American housing prices going back to 1890. It is based on sale prices of standard existing houses, not new construction, to track the value of housing as an investment over time. It presents housing values in consistent terms over 116 years, factoring out the effects of inflation.

The 1890 benchmark is 100 on the chart. If a standard house sold in 1890 for \$100,000 (inflation-adjusted to today's dollars), an equivalent standard house would have sold for \$66,000 in 1920 (66 on the index scale) and \$199,000 in 2006 (199 on the index scale, or 99 percent higher than 1890).

DECLINE AND RUN-UP Prices dropped as mass production techniques appeared early in the 20th century. Prices spiked with post-war housing demand.

BOOM TIMES Two gains in recent decades were followed by returns to levels consistent since the late 1950's. Since 1997, the index has risen about 83 percent.



A Likely Future of Home Values

The projected future of house prices is based on the last two real estate cycles.

The two previous downturns have been applied to the current boom. The curves are scaled to fit the average market trend since World War II.

Two previous downturns (scaled)

Overall market trend since World War II.

The real estate market is likely to "bottom out" around 2011.

This corresponds with a 43.5% correction in house prices.

In summary, the virtually uninterrupted rise of the All Ords from 2,945 in May 2003 to 6,500 in September 2007 does not trouble the stampeding herd. Quite the contrary: measured by the amount of earnings that \$1 presently purchases, and conveniently ignoring the ten-year PE ratio, the bulls reckon that during the past few years stocks have become *more attractively* priced. Thus they conclude: don't just buy stocks; dump the ones that aren't "performing" and focus upon the ones whose prices have risen in a practically straight upward trajectory since 2003. In plain English, the view of today's Australian mainstream parrots that attributed to the American humorist Will Rogers: "Don't gamble. Take all your savings and buy some good stock and hold it 'till it goes up. Then sell it. If it don't go up, don't buy it."

Corporate Earnings and Government Bond Yields

The bullish majority emphasises, in my view unconvincingly, not just that stocks are reasonably priced on what they regard as an *historical* basis. It also affirms, I think implausibly, that they're cheap on a *relative* basis. The mainstream maintains that stocks are inexpensive compared to bonds. Stocks are inexpensive because, for the first time in decades, the (one-year) earnings yield of the All Ords has exceeded the yield of (which is basically the rate of interest paid by) a five-year Commonwealth Government bond.

In "Mr Buffett on the Stock Market" (*Fortune*, 22 November 1999), Warren Buffett stated that the rate of interest paid by government bonds (for simplicity, let's assume that there's just one type and thus only one rate) is "one of the two important variables affecting investment results." (The other is the rate of growth of corporate earnings.) This rate "acts on financial valuations the way gravity acts on matter: the higher the rate, the greater the downward pull. That's because the rates of return that investors need from any kind of investment are directly tied to the 'risk-free' rate that they can earn from government securities. So if the government rate rises, the prices of other investments must adjust downward, to a level that brings their expected rates of return into line. Conversely, if [the yield of the government bond] falls, the move pushes the prices of all other investments upward. The basic proposition is this: what an investor should pay today for a dollar to be received tomorrow can only be determined by first looking at the 'risk-free' interest rate."³

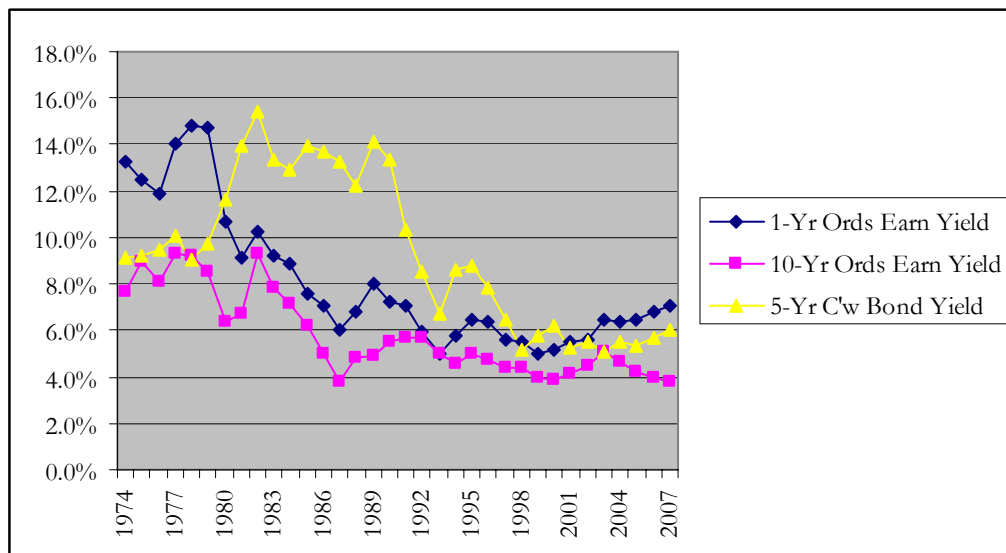
The reciprocal of the price-to-earnings ratio is called the "earnings yield." Consider again the numbers from 1974: regarded as a single entity, the companies comprising the All Ordinaries Index earned \$33.97 per share and the Index averaged 268. The Index's yield was therefore $33.97 \div 268 = 0.127$ (or 12.7%). What does this mean? Assume that in 1974 "All Ordinaries Ltd" paid none of its earnings as a dividend but instead ploughed everything back into existing and new operations. Also assume that in 1975 it continued to generate the same return on equity as in 1974; finally, assume that its PE of 7.9 remained constant from the first year to the second. If so, then earnings per share would increase to \$38.28 and the Index to 302. Under these circumstances, the return on one's investment (using the change of the Index as the measuring stick) would thus be (302 –

³ Hence it's little wonder why so many market participants clamour so incessantly for a lower Overnight Cash Rate (in Australia), a lower Federal Funds Rate (in the U.S.), etc. In the Welfare State of Credit (also known as Socialism for Overextended Debtors), central banks' principal objective (never mind their boilerplate about fighting "inflation," etc.) is to provide artificially cheap money, especially whenever anything is the matter. Lax monetary policy eventually causes a bust; but until the reckoning it underwrites inflated prices of stocks, bonds and titles to real estate – which is manna for leveraged speculators.

268)/268 = 12.7%. Recall that, all else equal, the *lower* is the PE ratio the better. Because the yield is the reciprocal of the PE, the investor should, all else equal, select assets whose sustainable yield is as *high* as possible.

Excluding everything except the recent past, the All Ords' yield (one-year basis) in Figure 2 affirms the bulls' refrain. But including as much history as valid and reliable data allow, things are much less obvious – and the ten-year earnings yield clearly falsifies the bulls' claim. Since 1980, the yield of a five-year Commonwealth bond has usually exceeded that of the All Ordinaries Index. Unfortunately for the bulls, the previous time the All Ords' one-year yield topped the Index's, namely during the 1970s, the yields of both stocks and bonds were much higher than they are today. For every \$100 used to buy such a bond in 1974, for example, one received roughly \$9.11 of interest; and every \$100 used to buy the Index in that year generated \$13.29 of retained earnings and dividends.

Figure 2: Another Reason Why the Bulls Say Things Are Just Dandy



The interest paid by the bonds remained broadly constant during the 1970s, rose dramatically and then stabilised during the 1980s, plunged during the early 1990s and has stayed roughly stable since 1998. In March 2007, the five-year bond yielded 6.05%. That is, every \$100 used to buy these bonds in that month will, each year during the next five years, produce \$6.05 of interest. Stocks' earnings yields, particularly on a one-year basis, have also fallen greatly since the 1970s. Every \$100 used to buy the All Ords Index in March 2007 generated ca. \$7.00 of retained earnings and dividends. That \$7.00 or thereabouts, say the bulls, compares very favourably to the \$6.00 or so generated by the \$100 used to buy bonds. The bulls state that, for the past several years, stocks have been cheap relative to bonds. Using the All Ords' one-year earnings yield, that's true; but using its ten-year earnings yield, it's false. And an eye to the more distant past prompts the retort: stocks and bonds are twice as dear now as they were in the 1970s and 1980s.

The "Historical" Growth of Earnings

In response, the bulls typically say: "But you're forgetting the growth of corporate earnings over time! In particular, you're ignoring the explosion of earnings since 2003."

Recall that the earnings per share of “All Ordinaries Ltd” have risen from \$33.97 in 1974 to \$407.56 in early 2007. During this third-of-a-century, earnings have multiplied 12-fold. If that sounds stunning (it mesmerises some bulls to whom I have related it), then restrain yourself: it’s equivalent to a compound rate of growth of 8.1% per annum. Recall (Newsletter 78-80) that major Australian banking, mining and retail blue chips have compounded their earnings per share by 7.9% per annum since 1965. During these two long intervals (1974-2007 and 1965-2006), Australian listed companies great and small have grown their earnings at an average compound rate of roughly 8.0%.

This long-term “base” rate of growth, which doesn’t take into account the RBA’s relentless destruction of the \$A’s purchasing power, is vital to bear in mind. These days the bulls, whose historical perspective typically begins in the 1990s – if it exists at all – tirelessly state that since 2003 the rate of growth of earnings has been outstripping its “historical average.” They also insist, thanks to voracious Chinese demand and omniscient and omnipotent rulers at Canberra and Martin Place, that earnings will continue to defy historical gravity. “Shares Tipped To Rise for Three Years” (*The Australian*, 8 May) is typical. “Global financial markets including Australia,” it proclaimed, “have been judged by a leading Wall Street company as not overvalued.” One of this company’s senior executives, doing the rounds in Oz, said “share prices would rise for at least the next two or three years. The main driver is likely to be the maintenance of corporate profitability.” Hence it bothers the bulls not at all that, by the historical standard which they constantly mention but seldom justify, the prices of stocks have since the mid-1990s been high relative to their earnings – but that only since 2003 have earnings grown abnormally rapidly. Like the Shar Pei (a breed of dog whose puppies have many deep wrinkles but “grow into their skin” as they mature), so too, it seems, the bulls assume of the ASX: the continuation of the recent bonanza of profitability will in time confirm that today’s prices of stocks are, after all, attractive.

The Consumer Price Index

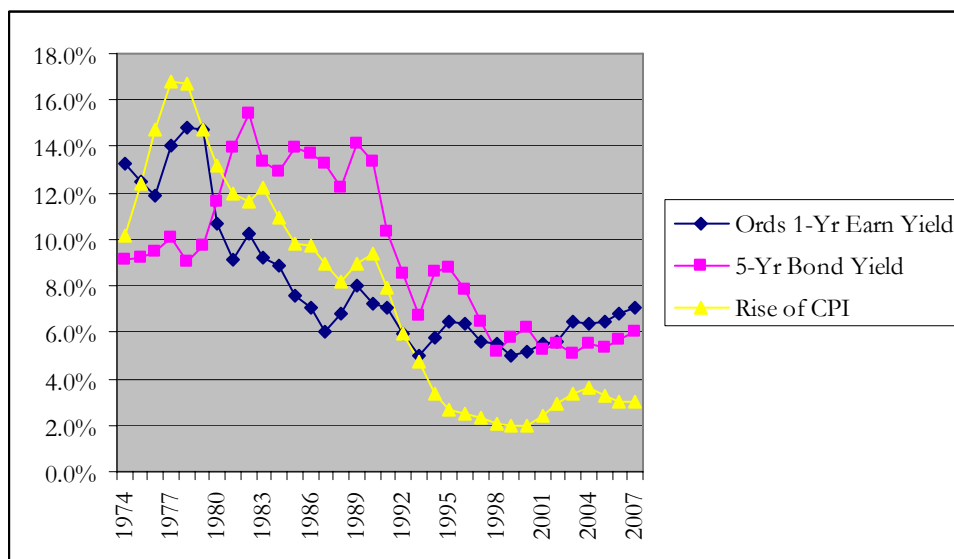
Why, compared to the 1980s, are stocks and bonds presently pricey? And why, compared to the 1970s, are they very dear? Why, in short, since the mid-1990s, have the prices of stocks been high relative to their earnings (and bonds expensive relative to their payments of interest)?

Figure 3 drops a very strong hint. The yields of stocks and bonds have fallen because the rate of growth of the Consumer Price Index (which almost everybody including the RBA misconceives as a synonym of “inflation”) has since the late 1970s dropped steadily, sometimes vertiginously and cumulatively drastically. In the 1970s and 1980s, the CPI and the yields of stocks and bonds were relatively high; subsequently, the CPI and yields fell; and now, as the bulls and the government never tire of reminding us, they remain comparatively low. The variation of CPI explains 87% of the variation of the five-year Commonwealth bond’s yield and 46% of the All Ordinaries’ earnings yield. Since 1974, a decrease of CPI of 100 basis points (say, from 8.0% to 7.0%) has been associated with a decrease of the bond’s yield of 54 bp (say, from 10.0% to 9.46%); and a decrease of CPI of 100 basis points has been associated with a decrease of the All Ords’ one-year earnings yield of 47 bp.

Although the mainstream utterly misconceives the *nature* of inflation, it understands one of its *consequences*. The lower the rate of inflation, the slower the erosion of the purchasing power of money; and the less the erosion, the lower the yield of stocks and bonds

required in order to compensate for inflation's remaining harmful effects. The mainstream rightly concludes that *if* inflation ceases (and assuming for simplicity that streams of earnings and interest remain unchanged in nominal terms), then investors, once they recognise that the purchasing power of these streams has increased, will bid upwards the prices – and thereby decrease the yields – of the securities emitting these streams. *If* the purchasing power of money rises, then yields will tend to fall.

**Figure 3: A Third Reason
Why the Bulls Are Charging**



But beware the fallacy of affirming the consequent: the fact that rates have fallen does not imply that inflation – properly defined – has decreased. It hasn't, and the purchasing power of money certainly hasn't risen. Central to the distemper of the times is the fact, ignored or unknown by bulls, that inflation in Australia and elsewhere has been raging since the mid-1990s and has now reached a level not seen in a generation. Using the low CPI as its cover, the RBA and its counterparts overseas have directly suppressed short-term interest rates (and indirectly suppressed long-term rates) well below their free market levels. Artificial or not, lower rates reduce the apparent cost of borrowing, and thus tend to beget higher corporate profits. I suspect that, like the low rates, these rising profits are to a significant extent artificial. Contrived or not, low rates and high profits have produced (among most market participants) steadily rising expectations – and upbeat valuations. Hence the generally-upward thrust of the prices of stocks, bonds and real estate, interrupted by the aborted market of the early 2000s, since the early 1990s.

The bullish thesis, to which most everybody in Australia presently seems to subscribe, thus rests ultimately upon four core contentions:

1. Thanks to central banks – after all, the Consumer Price Index has fallen from ca. 12% in 1982 to ca. 3% since 1995 – “inflation” has been vanquished. The CPI's fall has allowed the yields of bonds (i.e., longer-term interest rates) to fall.
2. Since 2003, corporate earnings have grown rapidly. Because “inflation” (as the mainstream misconceives it) and interest rates

will remain low, and because Chinese and other demand for Australian exports is bound to stay ravenous, earnings will surely continue to grow quickly.

3. Because CPI and interest rates have fallen and earnings have increased, the prices of stocks have risen; and because CPI and rates will remain low and corporate profitability high, stocks will continue to rise. Further, the decrease of the All Ords' (one-year, as opposed to ten-year) PE ratio since the late 1990s implies that the prices of stocks have not risen unduly. Quite the contrary: as a whole, the All Ords' one-year PE ratio and earnings yield stocks are undervalued rather than overvalued.
4. All's swell and confidence rules, OK? In particular, recessions are relics of the far-off past and concerns for the distant future. They are, in short, matters neither for today nor "the foreseeable future" (this is one of the bull's favourite phrases, for in their more exuberant moments they fancy themselves as prescient). As "Savvy Investors Keep Stocks Strong" (*The Australian Financial Review*, 19 June) put it, "the bottom line is, if there's any weakness in equities then investors should consider buying on the dips."

Do Trees – and Corporate Earnings – Grow to the Sky?

The trouble with the bulls' contentions is not just conceptual and empirical. It is also logical. They don't just misconceive inflation and ignore everything except recent history: they also decline to push their reasoning as far as it will go. As a result, they discount or disregard disconcerting implications that follow from their own premises. They don't seem to overlook things randomly; instead, they systematically neglect whatever augurs poorly for investors' prospects going forward.

Do Earnings Indefinitely Grow, or Ebb and Flow?

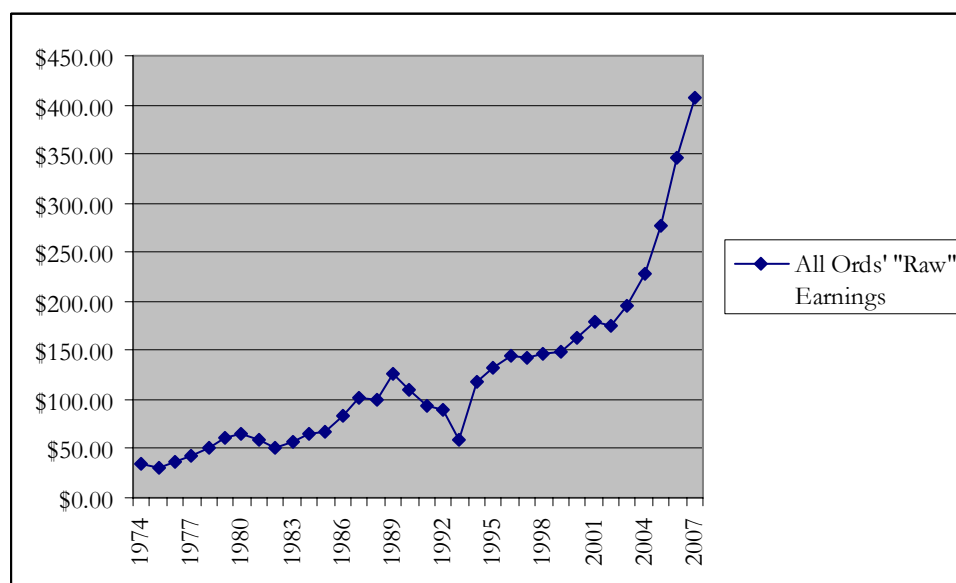
To see this, let us return to the earnings of the companies comprising the All Ordinaries Index. "All Ordinaries Ltd" earned \$33.97 per share in 1974 and \$407.56 (annualised) during the first quarter of calendar 2007. What about the intervening years? Figure 4 shows that "raw" (that is, unadjusted for CPI) earnings grew steadily during the 1970s, fell during the recession of the early 1980s, resumed their rise and reached a peak of \$126.06 per share in 1989. Earnings then contracted sharply 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, they have rocketed upwards since 2003.

Figure 4 illustrates four points. First, raw earnings can rise for very long periods of time. Second, what goes up eventually comes down. Yes, earnings typically rise year after year: but they can also fall sharply for several years in succession and thereby retrace much or all of their previous gain. What causes earnings to plunge? More than anything else, recessions do: hence the people who insist that earnings cannot fall are the same who believe that governments and central banks have eliminated the risk of recession. Third, Phoenix rises from the ashes. True, recessions raze earnings. But the firestorm eventually

passes; and after it does, green shoots appear and thicken, and earnings resume their upward march. Over the decades, then, “raw” earnings do not grow without interruption: they ebb and flow along a gradual upward path.

Even when unadjusted for CPI, the All Ords’ earnings usually stagnate but 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). Finally, the recent (since 2002-2003) explosion of earnings is not unprecedented. Most notably, they doubled during the five years from 1982 to 1987. The magnitude of this recent increase does, however, raise the question: will it continue? Can the present level even be maintained? To borrow the infamous words of Prof Irving Fisher of Yale University (who applied them to stock prices shortly before the Great Crash of 1929), have earnings “reached what looks like a permanently high plateau”? If the answer to these questions is “no,” how might a sharp deceleration of the growth of earnings affect the prices of stocks? How about an unexpected, severe and sustained fall of earnings of the kind that occurs during recessions? The bulls don’t answer such queries because they don’t ask them; and they don’t think about recession because, deep down, they believe that central banks and governments have eradicated this nasty species from our fair shores.

Figure 4: The Recent Explosion of Corporate Earnings: The Bulls Say It’ll Last



Do “Real” Earnings Grow Steadily?

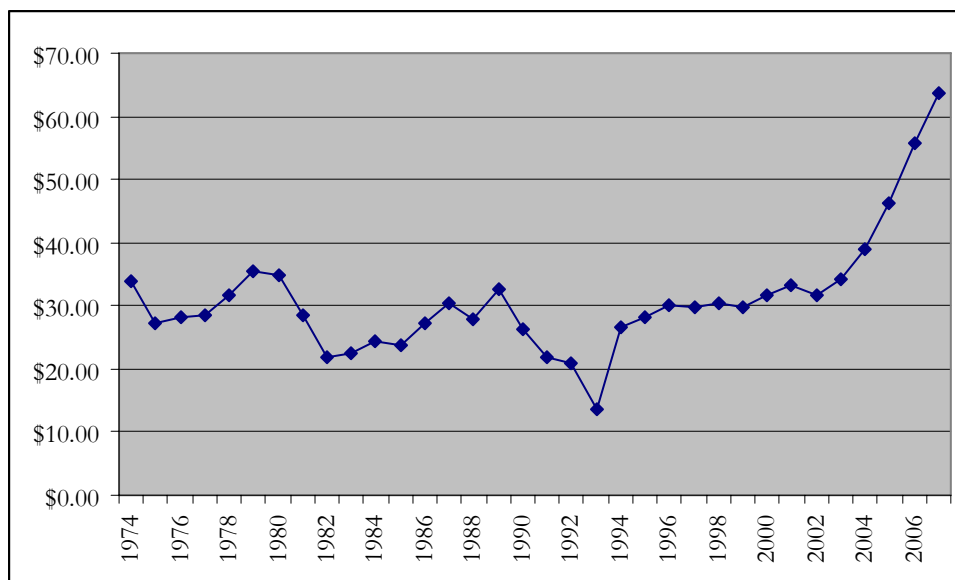
An increase of earnings of (say) 10% during a given year avails the investor nothing if the CPI also rises 10%. In this example, “real” – that is, net of the CPI’s rise – earnings haven’t grown at all. Hence the question: net of the CPI, by how much have the earnings of “All Ordinaries Ltd” increased over time?

By much less than the bulls think. Figure 5a expresses the data in Figure 4 net of the CPI. Holding purchasing power constant at its 1974 level, earnings did not increase until the end of the decade. They then plunged during the recession of the early 1980s. From

their peak of \$35.60 in 1979, they dropped 38% (to \$21.90) in 1982. Real earnings then rose during the remainder of the decade and reached a peak of \$32.63 in 1989 – a level below the starting point in 1974. Even worse, not only did earnings shrink drastically during the recession of the early 1990s (i.e., from \$32.63 in 1989 to \$13.60 in 1993, a drop of 58%): in “real” terms they sank 60% below where they stood in 1974!

Real earnings recovered as the country emerged from the recession of the early 1990s. Significantly, however, not until 2001, when they reached \$33.15, did they surpass the 1989 peak; and not until 2004, when they climbed to \$34.31, did they surpass the 1974 figure. Figure 5a thus teaches three sombre lessons. First, “real” earnings can grow very slowly – if they grow at all. Second, they fall drastically during recessions. Finally, although they recover from recessions, they can take years to do so. That’s bad news at any time, but will be particularly bad if Australia succumbs to recession anytime soon, and/or if CPI rises above the 3% ceiling established since the mid-1990s.

Figure 5a: Who Says Real Earnings Grow Steadily Over Time?



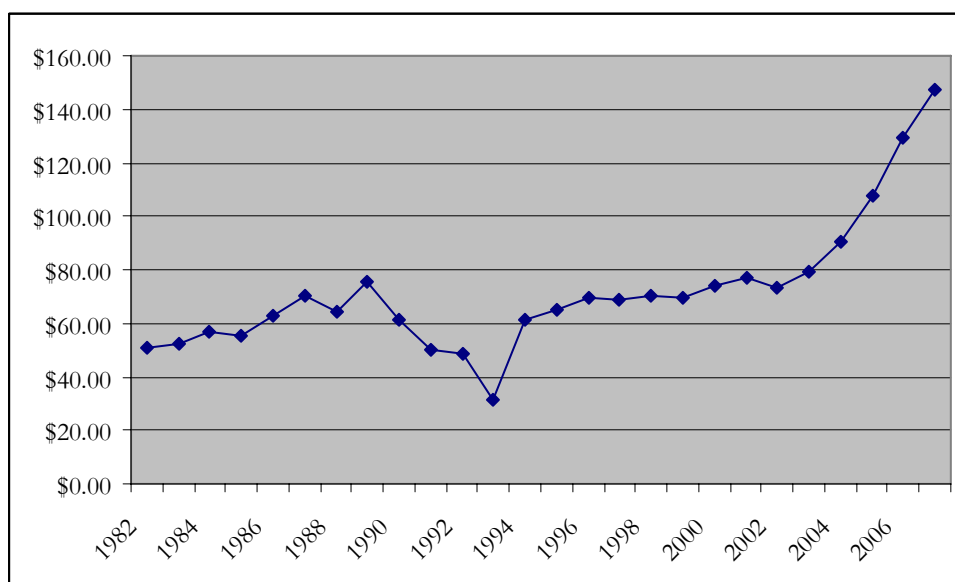
The bulls to whom Chris has presented these results have typically responded in one of two ways. The first is utter disbelief, followed quickly by the contention that the 1970s was a period the likes of which we will fortunately never see again, and should therefore be excluded from analysis and struck from memory. (I certainly hope and pray that Australia never again sees the likes of [Gough Whitlam](#) and [Malcolm Fraser](#). Further, and particularly if the evil socialist neocon ALP wipes the floor with the evil socialist neocon Liberal-National coalition, I pine for a worthy successor to that great patriot [Peter Walsh](#).)

Their second reaction is the assertion that, beginning in the early 1980s, central banks began to vanquish “inflation.” By this they mean the CPI’s annualised rate of growth decelerated from more than 8% to ca. 3%. Since the mid-1990s, they say, this battle has been won; further, the genie of “inflation” will not escape from the bottle into which central banks have allegedly trapped it. Accordingly, “relevant” historical analysis should omit the 1970s and begin in the early 1980s – if not in the mid-1990s. Like official Soviet

histories, which airbrushed certain people and expunged particular events, today's financial gatekeepers act and speak as if the 1970s never happened. That's convenient: as [Newsletter 72-73](#) showed, the losses sustained during that decade, when combined with the simultaneously rapid erosion of the \$A's purchasing power, rivalled the losses suffered during the Great Depression.

In fairness, the bulls implicitly make one very good point: the conclusions of historical analyses depend heavily upon the swathe of history selected for analysis. Let's do as one bull has suggested: replicate the analysis in Figure 5a, but exclude the 1970s and begin the analysis in 1982 – the year that marked the nadir of the recession of the early 1980s and the dawn of the low-CPI era. Let's, in other words, hold the \$A constant at its 1982 level and compare subsequent earnings to the base ("raw" earnings of \$50.78) in that year. The results of that exercise appear in Figure 5b. If the selection of 1974 as a starting point produces results that the bulls don't like, then surely this more recent starting point will produce much more congenial conclusions?

Figure 5b: Who Says the All Ords' Real Earnings Always Grow Steadily?



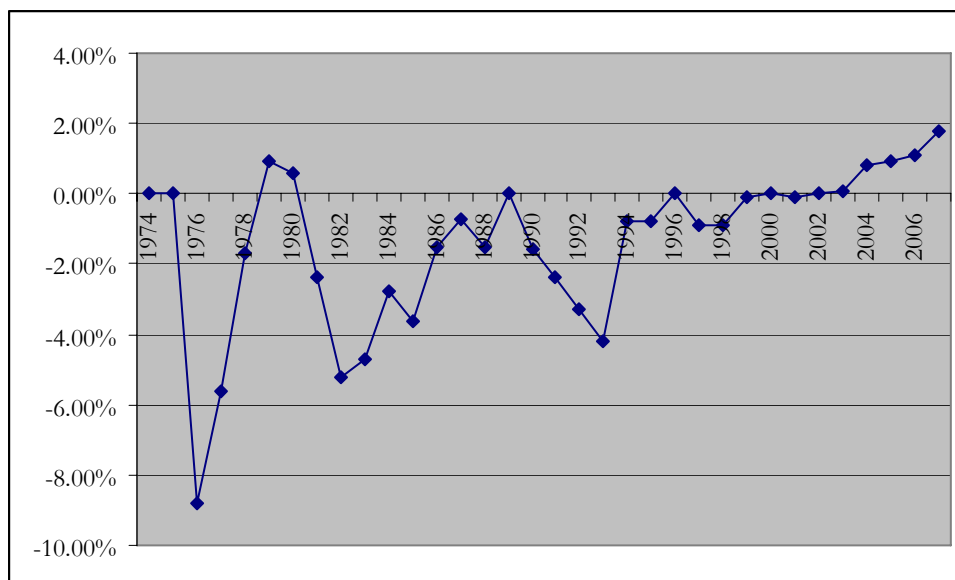
Not really. Figure 5b shows that, even when the CPI decelerates rapidly and then rises at "just" 3% per year, as it has done since 1995, the "real" earnings of companies comprising the All Ordinaries have stagnated for extended periods of time. They rose by 49% during the 1980s, from \$50.78 in 1982 to \$75.61 in 1989. They then plunged 58% during the recession of the early 1990s, and reached a nadir of \$31.51 in 1993. At this bottom they stood 38% below their starting point in 1982. Crucial lessons thus remain: recessions rapidly crush real earnings; and once flattened by recessions, real earnings can take a very long time to reclaim their pre-recession peaks. Only in 2001, when they reached \$76.82, did they return to and rise above their 1989 level.

Considered in this light, the rapid acceleration of real earnings since 2003 provides at least as many grounds for concern as for celebration. The trouble is not just that virtually everybody takes it for granted that the present level will persist. Further, the market participants who have fuelled the All Ordinaries' relentless climb from an average of

3,078 in 2003 to 3,580 (2004), 4,341 (2005), 5,176 (2006) and 6,300 (mid-2007) insist that this very rapid rate of earnings growth, or one close to it, will continue. How realistic is that? Only if the bulls remove the 1970s, 1980s and 1990s from the computation of their “historical average,” and also remove any possibility of recession from the analysis, does this belief attain some semblance of plausibility. Moreover, where is the covenant stating that the mining boom will generate an eternal cornucopia? Who has countersigned it? And what credible law of economics or Act of Parliament has outlawed recession?

Figures 6a and 6b depict what I regard as a more realistic assumption that investors should make about the long-term rate of growth of the All Ordinaries’ real earnings. They restate the data in Figures 5a and 5b as cumulative compound rates of growth. That is, from 1974 to 1975 real earnings fell at a compound rate of 20.0% (this data point is omitted because its magnitude is so big relative to all others); from 1974 to 1976, they fell at a compound rate of 8.8%; ... and from 1974 to 2007, real earnings have grown at a compound rate of – brace yourself – 1.8%.

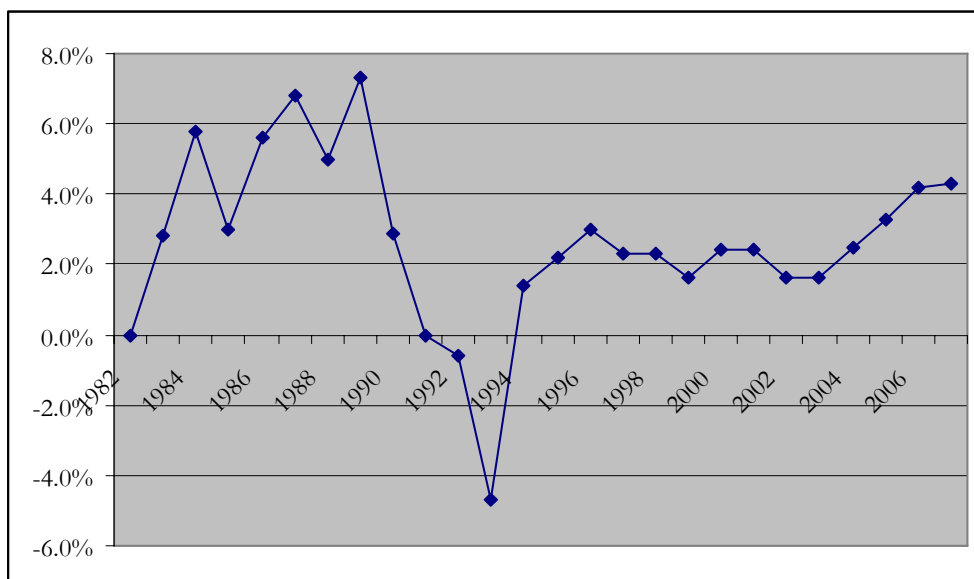
Figure 6a: The All Ords’ Cumulative Compound Growth of Real Earnings (Since 1974)



A comparison of Figures 6a and 6b shows that these cumulative compound rates of growth are sensitive to start and end dates. The shorter the interval the more variable is the rate; and over longer periods a more stable rate emerges. Taking 1974 as the starting point, real earnings did not grow – quite the contrary, they tended to fall – until the late 1990s. In the race between CPI and earnings, in other words, earnings usually lost. Notice as well how recessions spoil this already-thin gruel. For eight years, from 1974 to the trough of the recession in 1982, real earnings shrank at an annual compound rate of 5.2%; for 19 years, from 1974 to the bottom of the recession in 1993, they shrivelled every year at an average compound rate of 4.7%; and for 28 years, from 1974 until 2002, real earnings expanded at an annual compound rate of 0.0%. *That’s right: for nearly a generation after 1974, the earnings of the companies comprising the All Ordinaries index did not outpace the CPI!* Only the explosion of earnings during the past 3-4 years has been able to push the cumulative compound rate of real growth to 1.8% per annum since 1974.

This long-term result stems partly from the choice of an unflattering starting date. A more recent one paints a better – but not a dramatically better – picture. That is, from 1982 to 1983, real earnings grew at a compound rate of 1.0%; from 1982 to 1984, they grew at a compound rate of 7.7%; ... and from 1982 to 2007, they have grown at a compound rate of 4.3%. But again, the recessions of the early 1980s and early 1990s defaced this prettier picture. If one takes 1993 as the end point, for a decade the All Ords’ “real” earnings *shrank* at a compound rate of 4.5% per annum. And if one takes 2002 as the end point, then over these twenty years the earnings of “All Ords Ltd” rose at a “real” (i.e., CPI-adjusted) compound rate of slightly less than 2.0% per annum. So thank heavens for the minerals boom: only the explosion of earnings during the past 3-4 years has been able to push the cumulative compound rate of real growth to 4.3% per annum since 1982.

Figure 6b: The All Ords’ Cumulative Compound Growth of Earnings (Since 1982)



The average of the observations in Figure 6b is 2.8%. That is, from 1982 to 2007 the earnings of “All Ords Ltd” have increased at an average compound rate of 8.8% – reasonably close to the 1974-2007 estimate of 8.1%. This average comprises the CPI’s average rate of growth during these years (6.0%) and the average rate of growth of real earnings (2.8%). American data commencing in 1871, which Robert Shiller has collected and analysed, produce similar results.

Operating Leverage: Pleasure Today and Pain Tomorrow

Therein lies a big problem. In recent years in both countries, earnings have grown much more rapidly than these “base rates.” Similarly, given that Australian GDP net of CPI has tended over the decades to grow at ca. 1-3% per annum, is it reasonable to expect real earnings in this country to grow by 33% in one year (as they did, for example, from \$52.14 in 2003 to \$69.57 in 2004)? Can they repeatedly grow at a compound rate of 16% per annum over two years, or at 17% p.a. over three years? At a compound rate of 17% per year over four years, as they have from 2003 to 2007? In short, and as the bulls imply, is it different this time? The more your views about the future stem from the

“base rates” of the past, the more you will tend to discount the China, India and minerals booms; to doubt the permanence of low CPI and low interest rates; and otherwise to ignore the bulls’ chatter. If history is a roughly reliable guide, then Figures 6a and 6b imply that the answers to these questions will eventually be emphatically negative.

Warren Buffett seems to agree. He told *Fortune* (22 November 1999) “someone once told me that New York has more lawyers than people. I think that’s the same fellow who thinks profits will [always grow faster than] than GDP. When you expect the growth of a component factor to forever outpace that of the aggregate, you get into certain mathematical problems. In my opinion, you have to be wildly optimistic to believe that corporate profits [as a percentage of GDP] can, for any sustained period, hold much above 6%. [Since 2003 in both Oz and the U.S., they have exceeded 12% of GDP]. One thing keeping the percentage down will be competition, which is alive and well. In addition, there’s a public policy point: If corporate investors are going to eat an ever-growing portion of the American economic pie, some other group [namely wage earners] will have to settle for a smaller portion. That would justifiably raise political problems – and in my view a major reslicing of the pie just isn’t going to happen.”

Why Have Profits Recently Exploded?

But only during a slump does the crowd heed Mr Buffett’s words of caution. These days, the extrapolation of recent history into the distant future yields complacent and even exuberant expectations. Around the world, the upsurge of corporate profits and the stagnation of household incomes have been among the most striking features of the past four years. In 2003, global profit margins sank to their lowest level in more than a decade; by 2006, the most recent year for which data are available, they had risen to unprecedented heights. Never before has the average company made as much money as it does today, and never before have its fortunes improved as rapidly as they have since 2003. Why have these things happened, and where might profits head from here?

With respect to the first question, it’s not the “China effect” (also known as the “post-industrial effect”). Bulls allege that China’s emergence as the world’s workshop has placed downward pressure upon manufacturing costs around the world and has tended to push less efficient and profitable non-Chinese companies out of manufacturing. These developments, in turn, have allegedly enabled Western multinationals to become “platform companies” that concentrate upon high-profit pursuits like R&D, intellectual property and “brand management,” and to divest to the developing world supposedly unprofitable activities like making tangible objects.

The facts speak otherwise. Since 2002, China’s trade surplus has grown from \$US25 billion to more than \$US300 billion. This sum denotes what Chinese entities earn selling to foreigners less what foreigners earn selling to Chinese firms. Chinese goods and services are displacing more revenue from non-Chinese companies selling on their home turf than are non-Chinese companies selling to China. For most firms in most countries, profits derive mostly from domestic sales. Accordingly, if anything China’s expanding surplus has exerted *downward* pressure upon the profits of non-Chinese firms. That is, absent the Chinese penetration of foreign markets, the profits of non-Chinese firms would have risen even more than they actually have. China’s biggest trade surplus is vis-à-vis the U.S.; hence it’s not surprising that the loudest howls of anti-Chinese outrage are coming from American firms and their employees.

Two additional facts contradict the “post-industrial effect.” If it holds, then (a) returns on equity should be higher in the developed than in the developing world and (b) within the developed world, companies that have adopted a “post-industrial” business model should be more profitable than those that haven’t. Data collected by funds manager Grantham, Mayer & Otterloo (GMO) say otherwise: ROEs are now higher (and since 2003 have risen more quickly) in developing than in developed countries; and within the developed world, the profitability of capital intensive companies has outstripped that of companies relying upon intangible capital such as patents, brands, etc.

Why the sudden increase of profitability around the world since 2003? Bulls also cite the “financial services effect” – the ever-growing size and influence of financial services firms and the ever waxing tide of their profits. There’s something to this: in Australia over the past decade, the profits of providers of financial services have risen far more rapidly than those of non-financial firms. But a trend evident for a decade is at best a partial explanation of another one apparent for five years. The bulls also point to the “inflation [low-CPI) effect.” It leaks water for the same reason: in Australia and most other countries, CPI has been relatively quiescent for a decade or more.

**Table 1:
Operating Leverage Giveth and Taketh Away**

Time 1	Time 2	Time 3
Company A		
\$100 of Sales	\$110 of Sales (up 10%)	\$99 of Sales (down 10%)
\$88 of Costs	\$92.40 of Costs (up 5%)	\$87.78 of Costs (down 5%)
\$12 of Pre-Tax Profit	\$17.60 of Pre-Tax Profit	\$11.22 of Pre-Tax Profit
Company B		
\$100 of Sales	\$110 of Sales (up 10%)	\$99 of Sales (down 5%)
\$98 of Costs	\$102.90 of Costs (up 5%)	\$97.76 of Costs (down 5%)
\$2 of Pre-Tax Profit	\$7.10 of Pre-Tax Profit	\$1.24 of Pre-Tax Profit

If these structural (so say the bulls) factors don’t adequately explain the recent boom of profitability, then what does? Something called “operating leverage.” If a company’s costs are largely fixed relative to sales, as those of many companies are, when revenues rise or fall by a given percentage then profits tend to change by a far greater percentage. What’s more, this effect tends to flatter otherwise mediocre (from the point of view of profitability) companies. To see this, consider an example derived from Peter Lynch’s book *One Up on Wall Street* (Fireside, 1989, p. 221).

Table 1 depicts stylised data from two hypothetical companies under three imaginary scenarios. Consider first Company A. At Time 1 (say, the relatively low-profit situation prevailing in 2003), A earns \$12 for every \$100 of sales. That is, its gross profit margin is $\$12/\$100 = 12\%$. Let us say that business subsequently improves (Time 2), representing the reality since 2003, and that A has been able to increase its sales more quickly than its costs. If sales have increased by 10% and costs by 5%, then it will earn \$17.60 per \$100 of sales. Note that its profit margin per \$100 of sales increases by one-third, from 12% to 16%, and that its pre-tax profit rises by 46% (i.e., from \$12.00 to \$17.60). Consider now Company B. At Time 1, B’s costs relative to sales are much higher than A’s, and so B

earns only \$2 for every \$100 of sales. Clearly, per \$100 of sales B is much less profitable than A. Let us say that business subsequently improves and that B increases its sales more quickly than its costs. If sales rise by 10% and costs by 5%, then B's profit rises by a stunning 255% (i.e., from \$2.00 to \$7.10) and its profit margin by 222% (i.e., from 2% to 6.45%). For low-margin companies whose costs are relatively fixed and whose sales more variable, a boost to sales works wonders for profit.

The problem is that what operating leverage confers it can also withdraw. Accordingly, when business deteriorates and sales fall, costs do not fall as much. Let us say that conditions worsen (Time 3) such that Company A's sales fall by 10% (i.e., from \$110 to \$99) but that its costs fall only 5% (i.e., from \$92.40 to 87.78). Its pre-tax profit thus reduces from \$17.60 to \$11.22 (i.e., by 36%) and to \$11.33 per \$100 of sales – which is less than at Time 1. Company's B's situation is far worse. If from Time 2 to Time 3 its sales fall 10% and its costs by only 5%, then its pre-tax profit shrinks by 83% and to a mere \$1.24. Expressed per \$100 of sales, Company B's profit margin is just 1.25% – which is 38% less than the 2% at Time 1. *From an investor's point of view, never mind the boom between Time 1 and Time 2: both A's and B's – but particularly B's – profitability has fallen from Time 1 to Time 3.* Operating leverage is thus a sweet nectar to gulp during good times, particularly for companies with low profit margins; but it's a bitter pill to swallow when the business cycle turns inclement. Given the eventual costs of the bust, who really wants the transitory benefits of the boom?

Whither Corporate Profits?

What has driven the extraordinary growth of profitability around the world from 2003 to 2007? The short answer is the remarkable growth of GDP. Stripped of its complexities and absurdities, which are many and varied, GDP measures consumption. In the three years from 2003 (2006 is the most recent year for which data are to hand), household and government consumption grew more strongly than in any other three-year period of the previous 25 years. The worldwide uniformity of this growth of consumption is also unprecedented. The percentage of countries mired in recession has been, as nearly as the International Monetary Fund can determine it, close to or at an all-time low. So too has been the percentage of firms in distress (as determined by S&P and other major ratings agencies). In short, since 2003 a constant and cumulatively massive “consumption surprise” (that's what GMO, who've been caught as flatfooted as Chris, have dubbed it) has unfolded before our eyes.

Normally (that is, since comparable international records began to proliferate in the 1960s), consumption rises after and because wages have risen; and if wages stagnate then so too will consumer expenditure. But in this respect as well, the years since 2003 have been anything but usual. Never during a boom have wages grown so sluggishly. On 30 May, The Melbourne Institute released research showing that the average Australian household's income (net of tax and CPI, and including government handouts) was only 5% higher in early 2007 than in early 2002. That's a compound rate of growth of 0.9% per annum; and without hefty increases of government payments to families, the average household's real income would have fallen. ABS data released on 27 June corroborate this figure: in 2001-2006 and net of CPI, median household income grew 0.2% per year in Sydney, 1.0% per year in Melbourne and 3.0% per year in Brisbane.

Further, the Melbourne Institute estimated that although the income of dual-income households without kids rose at a compound rate of 2.3% p.a., the incomes of ca. almost

40% of all households have – even after the receipt of tax cuts and government handouts – fallen in real terms since 2002. And the rate of growth of real income seems to be decelerating. According to the ABS, real wages increased 20.8% during the period 1995-2006, i.e., at a compound rate of 1.7% per year. The MI's Director blandly stated that this meagre growth "is less than might be expected, given the average increase in GDP per person of about 12% over the past five years." Why the discrepancy? "A greater share of economic growth is going to company profits than wages." A similar situation prevails in the U.S.: according to studies cited by *The Wall Street Journal* (25 May), "American men in their 30s today are worse off than their fathers' generation. The typical American family's income has lagged far behind productivity growth since 2000."

Why is the average Australian household's real income barely growing? One reason is that the supply of labour is growing relative to its demand. Since 1996 migration to Australia has risen 50%, to ca. 150,000 per year, and presently stands far above its post-Second World War average as a percentage of the workforce. Further, tax incentives and other regulations including work-for-the-dole schemes are encouraging people hitherto outside the workforce to (re)enter it. Moreover, competition from countries with productive but lower-paid workforces is exerting downward pressure upon wages. In the 1990s, Aussie firms could not so easily "outsource" production to Asia. Today, they can.

Within the average Australian household, then, income has grown slowly and consumption has risen quickly. Globally, the situation is akin to that described in the first two columns of Table 1: aggregate profits in Morgan Stanley's All Country World Index have risen 150% (in terms of \$US) since the 2002 low, but global GDP by only 50%. Around the world, profits have outstripped sales, consumption has outpaced wages and the fortunes of corporations have clearly waxed relative to those of workers. As *The Australian* put it (4 June), "business is winning the age-old tussle between labour and capital hands down." It's not true that rich corporations are getting richer and poor workers are getting poorer. But it is true that the net worth of shareholders (calculated at present market prices) is increasing more rapidly than that of employees. Considered as a portion of GDP, wages and salaries in Australia, Britain and the U.S. have fallen steadily for a decade and very sharply since – you guessed it – 2002-2003. For many of today's employees, making ends meet is no mean feat and the dream of home ownership is (without plenty of help from the oldies) receding from reach.

Given that people's wages have grown slowly, how have they been able to consume so robustly? The supply of credit has never been more abundant, and the demand for it has never been more voracious. Once shunned and feared, debt has become a necessity and an allegedly firm path to financial security; and in Australia, Britain, Canada, NZ and the U.S., the propensity to save has plumbed depths not seen since the Great Depression. In the 1930s, "dissavers" in these countries were deeply worried and often destitute. These days, they are typically upbeat and gainfully employed. They are happy – indeed, eager – to live beyond their means because they believe either that their income will increase or the prices of the house, shares, etc., they have borrowed to buy will rise enough to service their debts. Nobody knows how long this bacchanalia will persist or how severe the retrenchment will be once the well runs dry. But I am reasonably confident that negative savings rates in Australia and elsewhere will not persist forever. *The Australian Financial Review* (6 June) put the point well: "the average Australian family saves nothing out of the money coming through the door and is continuing to borrow, year in year out, an extra 15% while their incomes are growing at only 4% [in "raw" terms unadjusted for CPI]. It just cannot continue indefinitely."

What, then, does the future hold for corporate profits? Buried in a quiet corner within *The Budget and Economic Outlook* issued by the Congressional Budget Office in August 2006 are some eye-popping projections. Pre-tax profits in the U.S. are expected to fall 8% during 2007, to continue on a downward trajectory through 2010 and to remain below their current level (in nominal terms) until 2016. The CBO thus projects that the ratio of corporate profits to national income will decline significantly. As a percentage of GDP, they are expected to fall from 13.4% in 2006 to 9.0% in 2014 – which, by the way, is still 50% above the historical average Mr Buffett cited. In contrast, things will become somewhat less severe for workers: wages and salaries are projected to rise from 45.0% of GDP in 2006 to 45.9% in 2010. The decline of corporate profits will cause tax payments to fall from a peak of \$US340 billion in 2006 to \$US304 billion in 2010 – at a time when Uncle Sam’s liabilities are rising very rapidly. Oh, and the CBO expects that any revisions to its projections regarding profits are more likely to be downward than upward.

Australia’s Bullish Tinker Bells

“Clear Air Ahead in Blue-Sky Rally” proclaimed *The Australian Financial Review* (15 May). On that day, when major indices finished just short of yet another record close, “market watchers said there was little bad news to stop the local market pushing higher.” Said one: “inflation is retreating, if anything, you have got good growth and good macroeconomics, so it’s like ‘what’s in the way of equities rallying?’ ... You’re in this really conducive environment. I don’t know when it’s going to stop, but there’s no reason why it should actually go into reverse gear and start falling backwards any time soon.” Like this bull, I do not know when the music will stop. But it always has, and at some point I expect that it will again. Unlike the stampeding herd, I conclude that conditions today are deceptive rather than conducive. In summary:

1. The crowd, assured by the government and its mascots that inflation is solely a consumer price phenomenon, rejoices that the CPI is low. Yet inflation has always been and everywhere remains a money supply phenomenon. Sometimes, as in the 1970s, its consequences are most apparent at the supermarket; and at other times, such as the past decade, its effects are most marked in markets for real estate, stocks and other financial assets. These varied consequences stem from a single source: inflation is manufactured solely by central banks. It has accelerated throughout the Howard-Costello era and is now sprinting at the fastest pace since Gough Whitlam occupied The Lodge.
2. The trouble is that inflation today paves the way for recession in the future. Further, the policies that delay recession today simply intensify it tomorrow. The crowd, which idolises central bankers and dissects every word they utter, reckons that inflation has long been vanquished and that monetary conditions are presently “mildly restrictive.” I apprehend that inflation has raged for 15 years and has accommodated ever less creditworthy borrowers.
3. The stark reality is that we once again have monetary conditions that last saw the light of day during the 1970s. Yet we also have asset prices that presuppose that these conditions can never return. We have, in effect, an RBA that resembles a demented traffic cop who switches to green all the lights at an intersection. We also have market participants who, convinced that bureaucrats’ signals invariably valid, are ignoring oncoming and cross

traffic. Thus far we've been lucky: occasional prangs have been the rule. But who says that multi-vehicle crashes involving severe injuries – or worse – cannot occur? Under these conditions, defensive drivers reduce their speed, redouble their vigilance and choose less-travelled routes wherever possible.

4. By the standards of the 1990s, and using the one-year PE ratio, Australian stocks are not expensive. But by the standards of the 1980s, they are not cheap; by the standards of the 1970s, they're very pricey; and using the ten-year PE ratio, they're dearer now than at any time (except 1987) since 1974.
5. Yes, by one measure (but not another!) stock are presently cheaper than bonds. But so what? By the "historical standards" that bulls constantly cite but seldom justify, the prices of both are unattractive.
6. Nobody knows whether it's different this time. But given that earnings, interest rates and returns have since the 1960s regressed to their long-term means, who's to say that the next decade won't resemble the 1970s more closely than the Golden Era (or should that be Gilded Age) since the mid-1990s?
7. Unadjusted for the CPI, earnings tend to rise over time. But in "real" terms they can stagnate for decades. Alas, bulls neglect this and three other sobering facts. Earnings typically grow much more slowly than most people realise; in both raw and real terms, recessions rapidly crush earnings; and once flattened, earnings can take years to reclaims their pre-recession peaks.
8. During the past 3-4 years, as bulls never tire of celebrating, earnings have grown at four or more times their average CPI-adjusted pace since 1982. The very high prices paid today for stocks imply that this high tide of good times will continue indefinitely. History warns us that it probably won't.

The conclusion from Mr Buffett's 1999 interview with *Fortune* – which he has not revised – deserves repetition. "Let me summarise what I've been saying about the stock market: I think it's very hard to come up with a persuasive case that equities will over the next 17 years perform anything like – anything like – they've performed in the past 17. If I had to pick the most probable return ... in a world of constant interest rates, 2% [CPI], and those hurtful [brokerage and other] costs, it would be 6%. If you strip out the [CPI] from this nominal return, that's 4% in real terms. And if 4% is wrong, I believe that the percentage is just as likely to be less as more."

Mr Buffett also issued a thinly-veiled (and I think unanswerable) challenge to the bulls. "Now, 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 internally-consistent manner. But the Tinker Bell approach – clap if you believe – just won't cut it."

Chris Leithner