



“For every action,  
there is an equal and  
opposite reaction.”

— Isaac Newton

Newton’s third law of motion



## Key Takeaways

- High-surf conditions often correlate with those that precede steep wave collapses.
- The high cost of “free” money causes the working-class to get poorer. This should also be alarming for the rich.
- All investing requires preparing for a wide range of possible scenarios.



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Over 20 years ago, Warren Buffett, chairman of Berkshire Hathaway, gave a speech on the stock market—a rare subject for him to discuss publicly. His main points during that July 1999 speech concerned two consecutive and amazing periods that American investors had experienced, and his belief that returns from stocks were due to fall dramatically.

He broke down the previous 34 years into two 17-year periods which, in the sense of *Newton’s third law of motion*, were astonishingly symmetrical. In the first period, as you can see in the table below, the Dow Jones Industrial Average (DJIA) gained exactly one-tenth of one percent over 17 years. The second period was marked by an incredible bull market that, as he laid out his thoughts, was about to end (though he didn’t know that). You couldn’t explain this remarkable divergence in markets by, say, differences in the growth of the economy. In the first period—that dismal time for the market—GDP actually grew more than twice as fast as it did in the second period. So, what was the explanation? Buffett concluded that **the market’s contrasting moves were caused by extraordinary changes in two critical variables—and by a related psychological force that eventually came into play.**

DJIA	Gain in GDP	Interest Rates (Long-term government bonds)
12/31/1964: 874	373%	4.20%
12/31/1981: 875		13.65%
12/31/1981: 875	177%	13.65%
12/31/1998: 9181		5.09%

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Here I need to remind you, dear reader, about the definition of “investing,” which though simple, is often forgotten: **Investing is laying out money today to receive *more* money tomorrow.**

That leads to the first of the economic variables that affected stock prices in the two periods—**interest rates**. At all times, in all markets, the smallest change in rates changes the value of every financial asset. You see that clearly with the fluctuating prices of stocks, bonds, real estate, oil, and every other financial asset.

As shown in the table on the previous page, interest rates moved *dramatically up* in the first period (that was bad for investors) and moved *dramatically down* (a boon for investors) in the second period.

The second critical variable is how many dollars investors’ expected to get from the companies in which they invested, by receiving a share of the **company’s profit** through corporate dividends. During the first period, investors’ expectations fell significantly because they were looking at a future they believed would be plagued by two negatives. First, they didn’t see much good coming in the way of corporate profits. By the early 1980s, Fed chairman Paul Volcker’s economic sledgehammer had, in fact, driven corporate profitability to a lower level that people hadn’t seen since the 1930s. Second, the prevailing sky-high interest rates eroded those meager profits even further. These two factors, working together, caused stagnation in the stock market from 1964 to 1981, even though those years featured huge improvements in GDP. **The economy grew while investors’ valuation of that business shrank!**

And then, the *reversal* of those factors created a period during which much lower GDP gains were accompanied by a bonanza for the market. First, you got a **major increase in the rate of profitability**. Second, you got an **enormous drop in interest rates**. Both phenomena were real and powerful fuels for a major bull market and, in time, a *psychological* factor was added to the equation: **Speculative trading exploded, simply because of the market action that people had seen.**

So, there you have an explanation of those two wildly different 17-year periods. The question is, how much do those past market periods say about its future? To suggest an answer, I’d like to look back over the 20th century. It was an incredible period. We had the advent of autos, aircraft, radio, TV, and computers. The per capita growth in U.S. output, measured in real dollars (that is, with no impact from inflation), was a breathtaking 702%. As a nation, we made relatively consistent progress throughout the century. So, you might think that the economic value of the U.S.—at least as measured by its securities markets—would have grown at a reasonably consistent pace as well.

That’s not what happened. We know from our earlier look of the 1964–98 period that parallelism broke down completely in that era. But the whole century makes this point as well. To break things down another way, we had three huge, long-term bull markets that covered about 44 years, during which the Dow gained more than 11,000 points. And we had three periods of stagnation, covering some 56 years. During those 56 years, the country made major economic progress and yet the Dow actually *lost* 292 points.

In his July 1999 speech, Buffett believed the favorable fundamental trends had largely run their course. For the market to go dramatically up from where it was then would have required long-term interest rates to drop much further or for there to be a major improvement in corporate profitability (which seemed, at the time, considerably less possible). Buffett’s point was essentially that, if past returns are substantially higher than one would have expected (based on valuations at the beginning of the period), it doesn’t mean that valuations are somehow broken or have “stopped working.” Rather, it’s an indication—even a confirmation—that current valuations may be extreme, and that future returns are likely to be disappointing. When valuation measures are extreme, the extra return you celebrate has simply been removed from the future. When valuation measures collapse, the shortfall of return that you suffer has also been added to the future. **It’s important to know where you stand in that cycle.**

As it happened, the annualized return of the DJIA (with dividends reinvested) would lag the 10-year Treasury notes for the next 10-year period from 1998 to 2008:

DJIA	DJIA Annualized Return (Dividends Reinvested)	10-Year Annualized Treasury Return
12/31/1998: 9181	1.69%	6.03%
12/31/2008: 8776		

How could this have happened? In a flourishing country in which people are focused on making money, how could you have had three extended and anguishing periods of stagnation? The answer lies in the mistake that investors repeatedly make—that psychological force mentioned earlier: **People are habitually guided by the rear-view mirror, and, for the most part, by the vistas immediately behind them.** What happened then should strike readers as eerily familiar today: the mere fact that share prices were rising so quickly became the main impetus for people to rush into stocks. **What the *few* bought for the right reason in 1925, 1981, and 2009, the *many* bought for the wrong reason in 1929, 1964, 1998 and now, in 2021.**

This is one thing I can never understand. To refer to a personal taste of mine, I’m going to buy coffee the rest of my life. When coffee goes down in price, we sing “Happy Days

Are Here Again” in the Hooper Household. When coffee prices go up, we weep. For most people, it’s the same way with everything in life they will be buying—except securities. When securities go down and you can get more for your money, people don’t like them anymore. **Newton’s Law: For every action, there will be an equal and opposite reaction.**

### The High Cost of “Free” Money

It always amazes me when policymakers think that by manipulating market prices, they can help an economy achieve better returns. The idea that maintaining abnormally low interest rates helps economic growth is a fallacy. **This is especially true in the case of interest rates.** Abnormally low policy rates is always accompanied by rising asset prices due to financial engineering, which makes the rich get richer, as they own the stock of *old* assets, while depressing the living standards of the working-class.

The reason is simply that low interest rates ultimately cause the savings rate to fall. This situation always leads to less capital spending and lower productivity. Thus, relying on low rates to stimulate economic growth is about as smart as imposing rent control as a way to boost housing supply. If policymakers set the price of rents, investors would simply reduce their investment in *new* housing.

Not only do these policies lead to *lower* economic growth, they also have a propensity to hit the living standards of the low-end workers and is unacceptable in political, social and moral terms, at least according to the late American political philosopher John Rawls. A “just” society is one in which the working-class see their standard of living rise consistently, he argued, and as a result they are comfortable with the rich also getting richer. But, if they see the rich get richer while they get poorer, politics can become difficult.

There are two direct ways that abnormally low interest rates

make the working-class poorer. First, unlike the rich, the working-class tend to keep whatever savings they can muster in cash. That’s why, **by depressing short-term interest rates, savers are deprived of legitimate income.** The rich, of course, take steps to avoid the “*financial repression*” (loss of spending power when interest rates are lower than rising prices) by getting out of interest-bearing instruments and into alternative reserves of value such as commodities and real estate. Second, since most of us spent our early working life with limited means, we all know from personal experience that the working-class spend most of their money on food, energy and rent. **Thus, as abnormally low interest rates drives up the price of assets, the price of staple items is pushed up, including food, energy, and rents.**

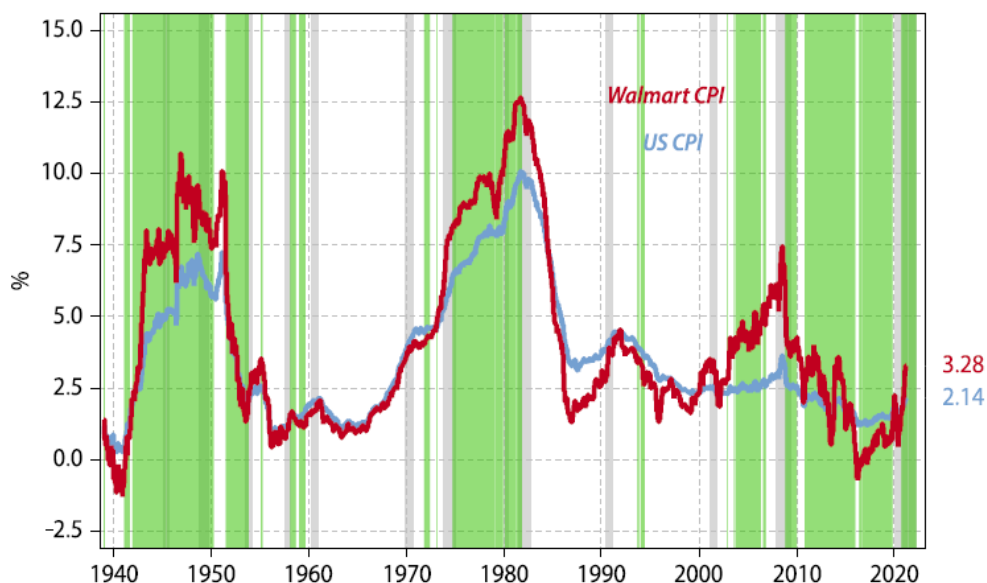
To show this point, Gavekal co-founder Charles Gave compared the inflation rate for the average US citizen (the US consumer price index) to a narrower measure comprising food, energy and rent, split equally in one-third proportions (which he calls the *Walmart index*).

The chart in **Figure 1** below shows the average annual rate of change for both indexes over five years. On this basis, the rate of inflation faced by the working-class is 3.3% and rising, a level that is 50% more than that faced by the average US citizen (by the way, the 12-month rate of change over the last year, the Walmart CPI is up 6.32% versus 3.31% for the US CPI.) At the very least, abnormally low interest rates can be seen to fail John Rawls’ test, and the result is the working-class continually getting poorer. Things may get worse still for the working-class as policy settings are presently more extreme than they have ever been in the past. I suspect that the *Walmart index* will continue to zoom upwards.

We looked next at how the policies that keep interest rates artificially low, thus sparking inflation in goods bought by the working-class, aren’t great for the wealthy, either.

**Figure 1: 5-year Annualized Growth Rate of the Walmart CPI and the US CPI**

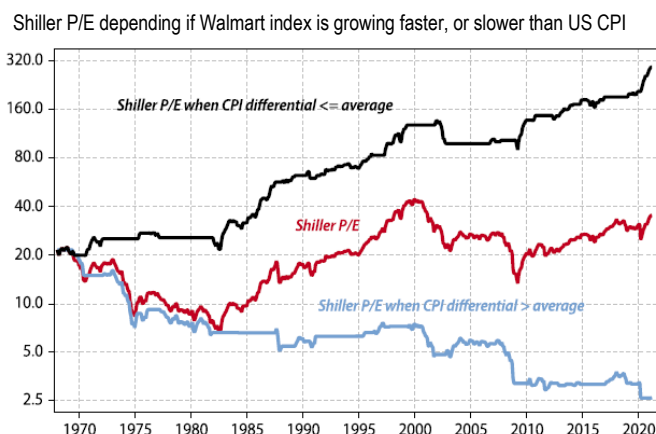
Shaded green: negative real rates on T-bill, pushed forward 1yr; grey: US recessions



Source: Gavekal Research/Macrobond

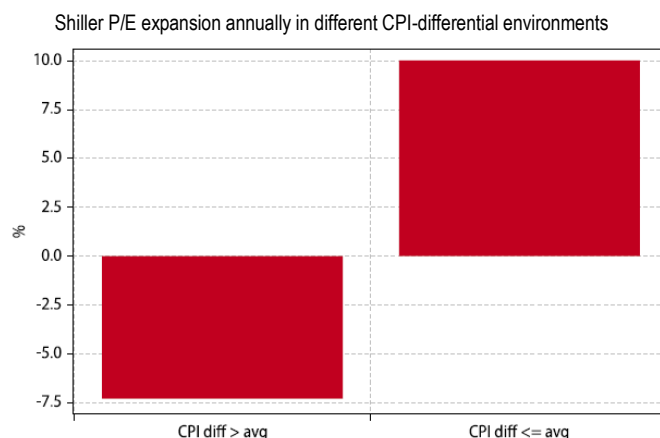
As you can see in the charts below, in periods when general prices, as expressed by the US CPI, rose more quickly than the Walmart index, P/E ratios expanded by 10% a year; when the reverse situation held, P/E ratios contracted by -7.3% a year. A situation where the working-class get poorer, and is bad news for the working-class, should also be alarming for the rich.

### When the working-class get richer, the rich do best



Gavekal-IS, Shiller, Bloomberg, Gavekal Research/Macrobond

### The working-class doing better is good for equity valuations



Gavekal-IS, Shiller, Bloomberg, Gavekal Research/Macrobond

## Investment Implications

It's not at all clear that investors appreciate how much of the stability of corporate profits over the past year has been the direct result of government subsidies. If they did, they would also recognize that rising labor costs and the proposed corporate tax hikes would place even more pressure on corporate profit margins than the current profit figures indicate.

As we observed in the 1970s—stocks have been useful hedges against inflation only after valuations have first been crushed, and typically only when the rate of inflation is declining. So, while faster inflation might boost economic growth, it would also be expected to decimate stock market valuations.

There's no question that speculative psychology can also support valuations over extended segments of the market cycle. Those Texas wind turbines that didn't work last winter? Seems like they didn't buy the heating option because they didn't think it was necessary. Oops. Nor was wind the only problem. Much of the natural gas infrastructure wasn't sufficiently winterized, either. Texas power generation was geared to, as one professor put it, work 99.9% of the time. But, that 0.1% can bite you in the assets, as all Texans learned.

All investing requires preparing for a wide range of possible scenarios. Amid significant economic and policy uncertainty and historically low yields, portfolio structures that provide flexibility to shift into opportunities that combine different real assets, such as commodities, gold and oil, may be particularly effective in hedging against inflation, as well as handling extreme events. After all, except for social media—where you're likely to find an unequal and opposite overreaction, for every action—Newton's Third Law of Motion is still alive and well.

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