

# How Much Longer Will The Good Times Roll?

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By James W. Coons

## I. Introduction

In contrast to the chorus of moaning and whining at the start of the decade, Americans today enjoy the lowest unemployment, inflation, and interest rates in a generation. The U.S. economy is more productive, profitable, and wealthier than ever before and than is any other country. The dollar is the world's only adult currency, and that pesky federal budget deficit has magically morphed into an ever-expanding surplus.

Our prosperity is not confined to the economic realm. The air and water are cleaner, and Americans are leading healthier and longer lives. Road rage is up, but so is philanthropy. And an appreciation for freedom and capitalism is springing up in surprising places all around the globe.

Reactions to these favorable developments fall into two opposing categories. The biblical view is that things are just too good to be true and that our prosperity will soon turn to dust. The secular interpretation is that our good fortune marks the dawn of a new age of endless bounty without disappointment. They are each wrong.

Through good management and hard work, we have created a prosperity that is sustainable, but not guaranteed. Let me address this point in the context of the economy and fixed income and equity markets.

## II. The Economy

Some have called this the "Goldilocks Economy" -- not too hot, not too cold, but just right. I prefer to think of it as the "Miller Lite Economy" -- great growth, less inflation.

The current economic expansion will become the second longest stretch of uninterrupted growth since at least the mid-1800s in December. And growth has been substantial. From 1991 to the present, the U.S. economy has expanded by an amount roughly equal to the entire economy of France seven years ago. At the same time, inflation has descended to a level not seen since the 1960s.

Great growth with less inflation is the byproduct of the highly competitive environment created by the opening of markets at home and abroad and a sound monetary policy.

Deregulation of the trucking, airlines, financial services, and telecommunications industries has exposed American businesses to greater rivalry domestically. Reductions in trade barriers have increased challenges from foreign firms. The effect of falling and now low inflation has been just as profound.

Twenty years ago, American businesses were far less efficient, in no small part because they could pass along cost overruns and other mistakes through higher prices. Cost overruns and other mistakes were all the more common, and as a result, undermined economic performance. Consumers were willing accomplices, eager to buy ahead of the next big price increase. Today, both behaviors are reversed.

Faced with customers who will not pay higher prices except in exchange for greater value, businesses are forced to operate more efficiently. Higher costs and unforeseen problems cut into profits. In this way, competition and accountability breed excellence.

We have benefited from the absence of major shocks, such as the OPEC oil embargo or military conflict. But for the most part, our good fortune reflects our own actions, and this is why it is sustainable.

Now, all will not forever be sweetness and light. Bad things have always happened, and will happen again at unpredictable times. But, to the extent that we continue to embrace open markets and preserve the purchasing power of the dollar by keeping inflation down, the economy will be more resilient, will suffer less, and will recover more swiftly from the unfortunate events that will inevitably occur.

Where does this lead? I long ago learned the cardinal rule of forecasting, which is: if you give a number, don't give a date, and if you give a date, then don't give a number.

But it is clear that the economy is not currently plagued by imbalances that have made it susceptible to trouble in the past. Inflation, which has been the leading cause of recessions, will be about 3 percent or less for the eighth straight year this year. Inventories are well in line with sales. And financial leverage in both the household and corporate sectors has fallen to long-time lows.

For the first time since the last recession, however, the economy does face some real risks. The turmoil in the economies of Southeast Asia could intensify and spread to the U.S. In the final analysis, Japan holds the key. Saddled with more than a half trillion dollars in bad or questionable loans, paralyzed by anti-competitive regulations, and undergoing its first real recession in a quarter century, the Japanese economy is struggling.

My assumption is that Japan will ride out the unfolding economic downturn and then gradually implement tax, trade, and regulatory reforms that will, over time, restore vitality to the economy. But, frankly, no one can know for sure. And there does appear to be some risk of a more serious deterioration that would affect the U.S. significantly.

Secondly, the year 2000 computer flaw could temporarily disrupt economic activity. The computer glitches that might occur starting on January 1, 2000 and the massive investments ahead of time to prevent and afterwards to repair them are one thing. A greater concern is the potential effect of Y2K-phobia on behaviors in advance.

For example, suppose you are thinking about buying a new car in the summer of 1999. But you have been hearing many dire predictions about anything with a microchip. So, you decide to drive your old car for another year and see what happens. Groundless or not, multiplied across hundreds of products and millions of consumers, this behavior might be able to derail economic growth -- especially if combined with heavier-than-expected fallout from Japan or some other unforeseen calamity.

By one calculation, the probability of a recession beginning this year is greater than 95 percent. I am comforted somewhat by a lesson that my brother, who is not a

mathematician, once taught me. Even when the odds are 95 to 5, he said, you still have about a 50-50 chance of being in the 5 percent.

What we can know with certainty is that the U.S. economy is in the best shape ever to withstand whatever trouble lies ahead. To bend the cardinal rule, I expect the economy to expand for a longer time and at a faster pace than most predict. Unless the fallout from Asia or the Y2K problem exceeds estimates, the economy will cross that bridge to the 21<sup>st</sup> century at about a 3 percent clip, although growth will be a bit slower over the balance of this year.

The positive effects of the mild winter, falling oil prices and interest rates, and the surge in inventory accumulation to catch up with demand will begin to fade. Already, the weakness gripping Asian economies is dragging down U.S. exports. In any event, there is every reason to expect that the next recession will be followed by an expansion that is comparable in length and strength to the current one.

### III. Fixed Income Markets

What does this future hold for financial markets? Let's consider fixed income first and then turn to equities.

I love the story of the bond trader who won \$10 million in the lottery. When asked what he was going to do with all of the money, he said he was just going to keep trading bonds until it was all gone.

To be fair, people say you can tell that economists have a good sense of humor, because they forecast interest rates a year ahead out to two decimal places.

So, let me be serious. It is a fact that the big swings in interest rates have always and everywhere been associated with the big swings in inflation. If inflation stays low for the foreseeable future, as I expect, then interest rates will fluctuate around a lower average than in the last ten years and with a slight downward trend that will take the yield on the 30-year Treasury bond below 5 percent.

But before you decide to load up on bonds, remember the story of the preacher, who during his sermon said, "If you want to go to heaven, stand up." Everyone in the congregation stood, except for one man in the front pew. The preacher looked down at him and asked, "Don't you want to go to heaven when you die?" And the man replied, "Yes, I do, but I thought you meant right now."

It may also be awhile before the bond yield reaches the Promised Land below 5 percent. The short end of the curve reflects what the Federal Reserve is doing today. The long end reflects what the Fed has done in the past and what investors think of it.

For at least the remainder of the year, I see the Fed making no changes to short-term interest rates. On the one hand, low unemployment and fast growth in money and credit have policy makers leaning toward raising rates. On the other hand, the very low rate of inflation currently and the possibility that trouble in Asia will spread to the U.S. keep them from pulling the trigger. Some even think that lower rates might soon be desirable. In the meantime, we will have a yield curve anchored by a 5.5 percent federal funds rate.

In the near term, I expect to see the long end increase by 50 basis points or so, as (1) measured inflation rises back to the underlying rate of 2.5-3.0 percent and (2) the

Asian effect amounts to little more than a glancing blow. But frankly, this clever little prediction puts me in the same league with that lottery-winning bond trader.

What I can say with conviction is that, if inflation stays down and trends lower as I expect, investors will continue to gradually squeeze the inflation premium out of bond yields over time. The result, perhaps in a few years, will be a much lower and flatter yield curve than we imagined possible a few years ago.

In fact, it is not only possible, it is retro. From the early-1950s to the mid-1960s inflation was low and stable, and the yield curve was low and flat. As inflation rose and became volatile from the late 1960s through the 1980s, the yield curve rose and steepened. In just the last three or four years, inflation has returned to the level and stability of a generation ago, and the yield curve has started to descend and flatten. Although the curve will certainly rise and steepen on occasion, the trend will eventually take us to a lower and flatter curve. There will be fewer opportunities for gain and fewer opportunities for loss, and returns will be correspondingly lower.

#### IV. Equity Markets

That brings us to the final subject: equities. Let me be among the first to say that the bull market, as we have come to know and love it, is all but over. It need not end with a bang, but I can hear the future whimpers of sorely disappointed investors already.

I do not mean to suggest that the current level of stock prices is unsustainably high or even that it is possible to know the right level for stocks. Rather, my point is that either (1) we have frolicked all the way through the rich field of double-digit returns or (2) stocks will continue on the tear of the last few years and become overvalued.

The following analysis is elementary, but as George Orwell said, "In certain times, the duty of every decent person is the restatement of the obvious." Given that surveys show investors expect the outsized gains of the 1990s to proceed indefinitely, this is perhaps one of those times.

Stock prices, of course, reflect the valuation of expected corporate earnings. And the source of the bull market since 1982 has been both higher expected earnings and higher valuations of those earnings.

Abstracting from dividends for a moment, earnings per share of the S&P 500 increased at an annual rate of about 5 percent from 1950 to 1982. The valuation of earnings, as measured by the price-to-earnings ratio, fluctuated during those 32 years but ended the period almost exactly where it started. As a consequence, prices increased at about 6 percent per year -- almost the same as earnings. The valuation of earnings did not change much, so prices increased at the same rate as earnings.

Two things changed after 1982. First, earnings accelerated from 5 percent to 8 percent. With no change in the valuation of those earnings, prices would have accelerated by a like amount. But valuations did change. They tripled, fueling an average increase in prices of 14 percent.

This performance can continue if valuations keep rising and earnings continue to grow so rapidly. The first is improbable. The second is questionable.

The main reason for the increased valuation of earnings is the victory against inflation. Lower inflation boosts corporate profits by raising economic growth, it

improves the quality of those profits, and -- most importantly -- it increases the value today of any given future stream of earnings.

Roughly speaking, P/Es can stay high, provided that inflation and interest rates stay low. But P/Es cannot go appreciably higher, because the long slide in inflation and interest rates is at or near the end. In fact, the best that stock prices can do from here is match earnings.

It is possible that the trajectory of corporate earnings underwent a permanent upward shift in the early 1980s and that growth will continue near 8 percent. Perhaps even the 16.5 percent rise since 1991 will continue. But it is far more plausible that the steeper rise in earnings represents a one-time adjustment, drawn out over many years, to the improved economic environment brought about in large part by disinflation. If so, then the trend in earnings and stock prices will be closer to the single-digit historical averages.

The bad news is that the party is over -- The push from rising valuations is behind us. The good news is that we do not have to go home yet -- as long as inflation stays low, stocks will avoid their only real long-term economic threat.

For the same reasons that falling inflation has been good for stocks during the last 15 years, high and rising inflation has been bad for stocks in the past. During the 123 years from 1871-1993, the real total return to large cap stocks has averaged 9 percent. In low inflation years, the return averaged 12 percent. And in high inflation years, it averaged just 3 percent. But the effects of inflation are even more profound.

The only extended period of poor performance by stocks in the modern era was from the late 1960s to the early 1980s. The S&P 500 fell by two-thirds in real terms during the 14 years beginning in December 1968. It took another 9 years to break even. The front car on that 23-year roller coaster ride to nowhere was the Great Inflation, which began in the 60s, raged in the 70s, peaked in the 80s, and vanished in the 90s.

The point of this extended history lesson is twofold. First, stock price appreciation will, at best, slow to the rate of earnings growth, which itself will slow dramatically from recent experience. One response is to invest overseas. In the next century, wealth will grow more rapidly outside the United States than within, making global indexing a possible antidote to the coming moderation in domestic returns.

The second point is that, barring a Great Re-inflation, there is good reason to expect decent average returns over time. Earnings and prices will go up and down over the course of the business cycle, but they will do so around a rising trend as long as the central bank continues to do a reasonably good job of maintaining the purchasing power of the dollar.

## V. Conclusion

How much longer *will* the good times roll? If by "good times," we mean doubling our money in stocks every third year, they are already over. But if we mean a fundamentally sound and growing economy with low inflation and interest rates and dependable returns to equities over longer stretches, then the good times are bound to keep rolling and rolling and rolling.