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OAKWORTH CAPITAL BANK

COMMON CENTS

Something to Think About

Yesterday, I was one of the speakers for what once was called 'career day' at my daughter's high school. These days, the official name is Kaleidoscope or something more catchy along those lines. Regardless, I talked about my job, gave some rudimentary advice, and, believe it or not, fielded a few questions. For my troubles, I got a hug, or three, and a loaf of really delicious banana nut bread. Truthfully, they didn't have to give me anything. I was more than happy to do it.

One young man asked me about Dow 20,000, and whether such a lofty level was going to be an impediment to any future rally this year. You know, that is pretty good for a high school student, really good even. I answered him as I would have an adult during the Q&A session of one of my presentations: "20,000 is just a number. If it is a psychological barrier for some barriers, then so be it. However, stock prices ultimately come back to corporate earnings. Now, will corporate earnings continue to justify 20,000? That is a different question altogether."

Then I asked him: what if I were to tell you I fully expect the Dow to be at least 50,000 by the time I retire? His eyes, and others, boggled a little. 50,000? Who would have thought that? Particularly in such a short period of time, because that guy is really, really old!

If I retire in 17 years when I am 65, I would be kind of disappointed if it weren't 50,000. It is just math, and here is my prediction for the Dow Industrials 17 years from today: 53,887. However, I don't plan to ever fully retire, as I would drive my wife absolutely crazy.

How did I get to that number? Well, I think US stocks will return lower than the accepted historical average of 10% for the next 13 years, when annualized. I have told clients to expect closer to 7% (total). If I assume a 2% dividend yield, that works out to be 5% principal appreciation. Then, in 2031, I fully expect the stock market will return HIGHER than the historical average for the next decade. If we assume a 12% total rate of return with a 3% dividend, that works out to be 9% principal appreciation per year. So, 13 years of 5% growth and then 4 years of 9%. The Dow was 20,245 when I did my calculations, so the end result was, voila, 53,887.

Obviously, we will have fits and starts along the way. There will be a few monster years in there, as well as some red ones. There will even be another financial crisis; this one stemming from Europe which will probably be less contagious (globally) than the last one. A lot will happen over the next 17 years, a lot. Still, if we are playing odds here, and I submit we are, 53,887 is my over/under for 2/10/2034. *Hey, if I could look into the future with crystal clarity, you probably wouldn't be reading this right now...but this is a number I can justify with math and reasonable expectations.*

For grins, the annualized principal return on the Dow Industrials from 2/9/2007 (closing price that Friday) to that 20,245 number this morning is/was, drum roll please, 4.87%. Obviously, this would include the market disaster in 2008, making that 5% estimate pretty good in my opinion.

There you have it, the math behind the prediction. It makes sense, but what if I had just blurted out "the Dow will be over 53,000 on this date in 2034"? What would your first reaction have been? I strongly suspect more than half would have thought I was crazy. There is NO way we would ever get to such a lofty level! After all, it has taken us well over a century to get to 20,000. How in the [heck] are we going to add in excess of 30,000 in less than two decades?

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Ah...the fun with math, compounding, and the difference between absolute and relative returns.

But, why did I predict the markets would ‘turn around’ in 2030? That seems like an odd year and an odd thing to write, doesn’t it? It does until you look at annual live births in the US. After all, people hit retirement age and their peak earnings years at different times.

Using only the government’s estimated annual live birth data, in 2012, more native born people should have turned 65 than 40 for the first time since 1981. The tables turned over in a big, big way that year. In 2011, 144,970 more people turned 40 as opposed to 65. The next year, 2012, get this, 558,589 more people turned 65 than 40. As a result, more people were hitting retirement age.

For grins, the difference was 652,212 in 2016, which should be the peak, although the numbers remain uncomfortably at or near 500,000 until 2026.

This trend continues to 2029 when it becomes statistically insignificant (at least my definition of statistically insignificant < 0.40%). In 2030, 397,894 more people hit the big 4-0 than the traditional retirement age. This trend continues until 2053. What’s more, in 2030, the initial Baby Boomers, those born in 1946 turn 84. I don’t mean to be morbid, but there are actuarial tables for a reason.

Basically, in 2030, more people hit their peak earnings years than retire, and the largest generation in our nation’s history starts, um, well, thinning at an accelerated pace. Put another way, there will be more people participating in the economy...higher labor force participation rates and employment to population ratios, all that good stuff.

This will work well for both growth and government budgets. That should be good for corporate earnings and, therefore, stock prices.

Of course, this assumes nothing more than the passage of time, and that we can continue to wallpaper over our financial shortfalls. Interestingly enough, and this could be a topic of discussion for another time, it would NOT be surprising if today’s backlash against immigrants completely reverses itself within 5 years as it becomes increasingly apparent we need more workers….bodies of any sort and at any payroll level to pay FICA. The more the merrier. Please come into the country with a phony SSN and pay into our little Ponzi scheme without any hope of getting it back. That sort of thing.

Hey, this isn’t a political commentary or some desire of mine. Nope, it is, again, just the math. Do you want to know why we ran a budget ‘surplus’ in the late 1990s and why we can’t seem to grow at much more than a historically tepid rate? Let’s just say economic growth can sometimes be a matter of lives and deaths, if you catch my drift.

Trust me, you will read a lot, and I mean a lot, about this topic in the future. I just can’t predict when the media will get around to discovering it. It baffles me it hasn’t, really it does.

Now, if THAT is the reason why I believe the markets will turn around in 2030 (*if not a year before*), you can reasonably intuit why I predict the markets will perform less than the historical average until then. You can think of it as two sides of the same coin.

This is why I favor a decidedly pro-business agenda at this time...anything to generate the necessary wealth in the economy to compensate for the current (and continuing) age demographic mismatch. To that end, please disregard anyone, from any party, claiming thus & so policy or tax proposal is going to wreck the budget. The budget is going to be a wreck regardless.

According to the Obama Administration’s last proposed budget, the accumulated deficit was/is going to grow an additional $9 trillion over the next 10 years. I would imagine this assumed no major changes to the current way of doing things, or what was then the way of doing things. While this would have kept our current Debt/GDP at a roughly constant level, there was/is little margin for error (assuming 2.5% GDP growth and 2% inflation). Why? Because there was extremely little growth in defense expenditures or the day to day operations of the Federal government. I might be alone, but I don’t/didn’t think that highly likely given the seemingly accelerated pace of global, shall we say, unease and the prospects for an additional 25 million new Americans over that time frame (0.75% annual growth).

Something to Think About Cont.

So, and I don’t mean to be cavalier, if that is past Administration’s probable case scenario, would it be wise to try something different? Or would ‘staying the course’ be the prudent approach? Remember, government receipts are generally around 18-19% of GDP, regardless of tax structure….at least that is what history suggests. If past performance is indicative of future results, and I supposed to say it isn’t even though the past is the best predictor of the future we have (sorry tea leaves), would it be wise to try to grow the economy as quickly as possible, understanding this has been an effective way of increasing the government’s coffers? Even if, say, changes to the tax code cause a short-term increase in the deficit in a calendar year or two?

That is an interesting topic for salon discussion….assuming you can leave social issues outside in the hallway. Frankly, those seem to be the biggest dividers between the two political parties at this time. That we need to grow the economy at a more rapid rate is an understood.

Admittedly, I might be a little unusual for someone who writes economic, or vaguely economic, newsletters. I quit a decent gig at a large company doing just that to help start a bank, and we don’t like using that word here at Oakworth. So, I have some measure of risk taking and tolerance in my DNA. With that said, I can also play around with numbers better than the proverbial ‘man on the street’….and the numbers tell me not doing anything pretty significantly different to grow the economy isn’t really an option.

In the end, the Dow Industrials at 20,000? That is pretty cool in absolute terms, but it is just a number. We had to get there once, didn’t we? But what of the future? Well, my over/under for 2034 is 53,887, and I attempted to explain how I arrived at that seemingly august figure. Hopefully, it made some sense, and I hope it comes to pass.

With that said, if we can get back to 3% GDP and 3% inflation, by hook or crook, before 2030, brother, I will take the **over** on that all day every day. Why? Because that would take my principal appreciation forecast for the next 13 years up to 6%. That 1% difference for those 13 years would take the Dow to, get this, 63,221.

I wonder what that kid would have said if I had told him that. Ahhh...the fun with math.

Disclosure