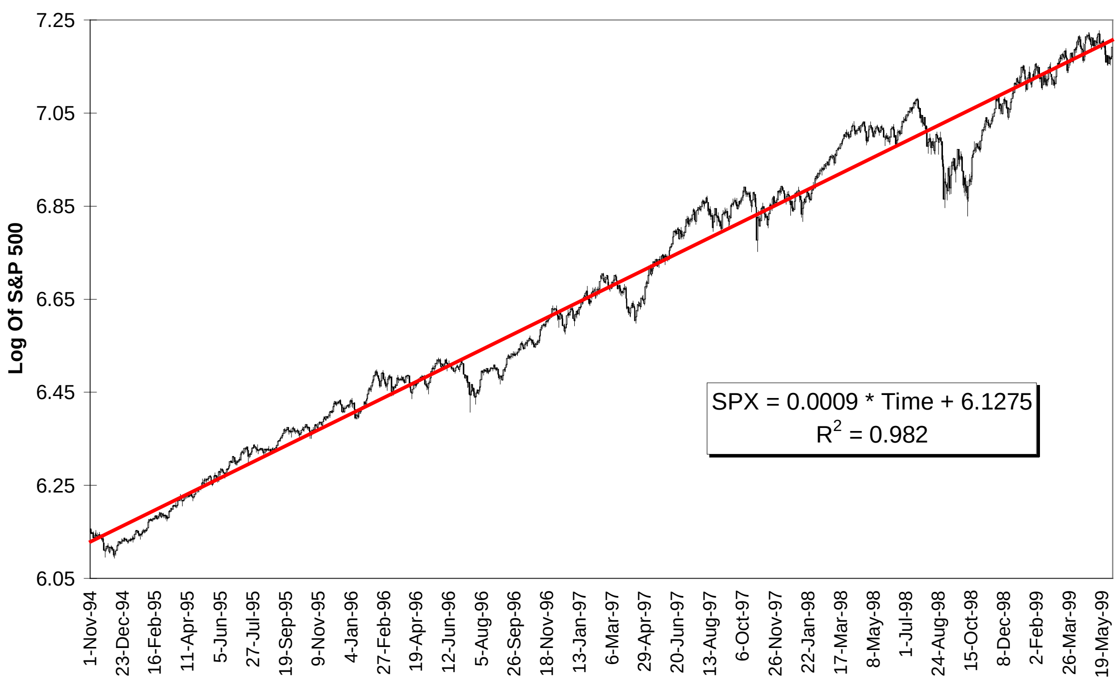
Everything You Know Is Wrong

Note: The annual satirical article on spurious correlation and the stock market has been moved up from January 2000 to today to sidestep any potential Y2K problems. As always, the data are real. Congratulations: You are reading both the first article of the new millennium and the fiftieth article to appear under this by-line.

Never give a sucker an even break: If she doesn't succeed at first, tell her to buy, buy again. This could be excellent advice. Imagine a proverbial silver-tongued devil hustling an equally proverbial rube back in November 1994 with the promise of a trading system capable of returning .09% per trading day in the S&P 500 index from then until June 1999, a trading system capable of explaining 98.2% of the growth rate of the index over that period. And of what mystical tools of the sorcerer/technician's black arts would this system consist? A fractal neural genetic econometric retracement breakout convergence engine? No, just a ruler. Or a ruler.com, if that makes you feel any better.

A Straight Line Has Done Fine



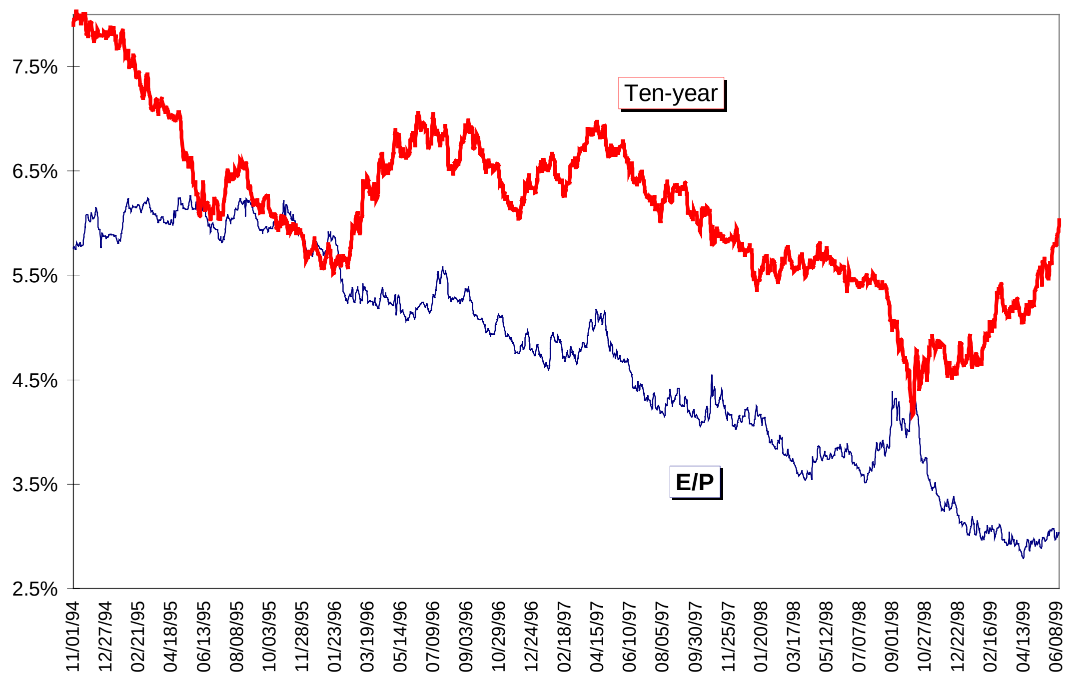
Of course, no one would ever slap a straight-edge down on a piece of semi-log graph paper and call it a trading system, probably not even in hindsight. There is no market for either anything so simple, or for anything that would never issue a sell signal, or for anything that would run so many red lights, both fundamental and technical. Only take the buy signals and ignore all the sell signals, because the title says it all.

Just Pay More

One of the time-honored tools of equity analysis is the price-to-earnings, or P/E ratio, which simply divides a stock's price by its earnings over a stipulated period. While this measure often is deceptive in that markets are discounting mechanisms looking forward in time, not backward over a reported period, and that earnings themselves are often artifacts of accounting practices, the trend in this ratio provides a decent measure of how much the market is willing to pay for a dollar of earnings.

P/E ratios cannot be taken in a vacuum; not only do individual firms and industries have different prospects for earnings growth, but the returns on equities must be compared to returns on other investments. The Federal Reserve Board is rumored to pay close attention to the relative returns of Ten-year Treasury notes – a more appropriate discounting horizon than the Thirty-year bond – and the earnings-to-price ratio. The E/P ratio, the reciprocal of the P/E, is a proxy for the prospective yield on equities.

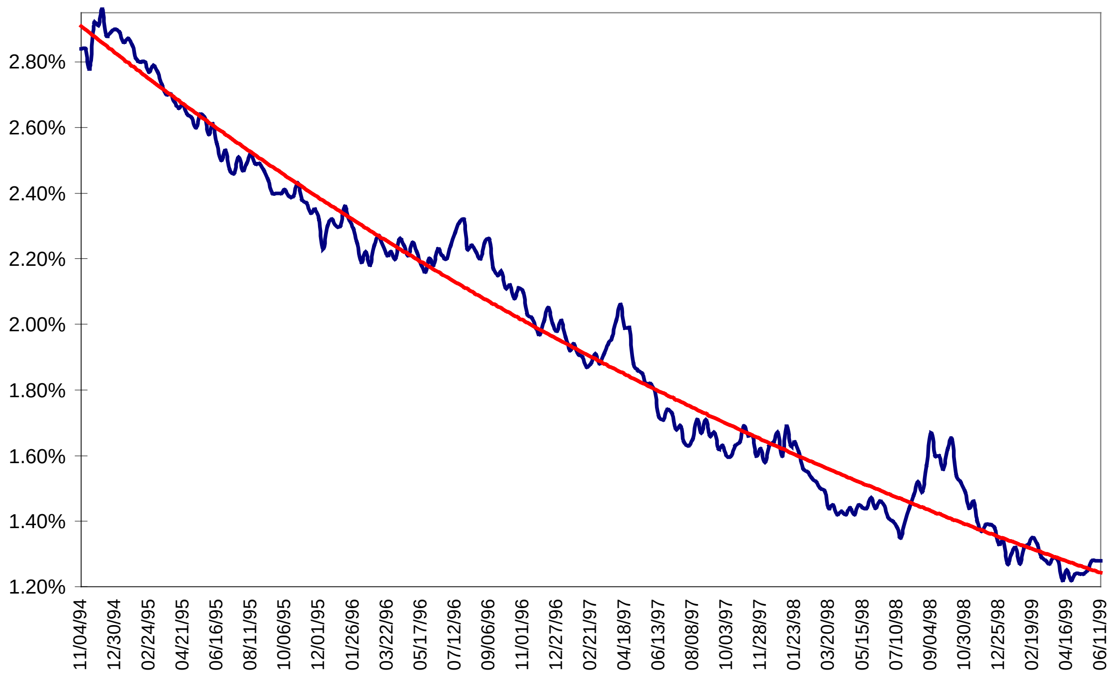
S&P 500 Earnings/Price And Ten-year Note Yield



The steady decline of the E/P indicates investors have been willing to pay ever-increasing prices for a dollar of earnings from equities. Yields on Ten-year notes, which have been climbing at the time of this writing, are now 300 basis points higher than the E/P yield. The disparity in yields correctly reflects the ability of earnings to grow over time, but also reflects an extraordinary degree of optimism about both earnings growth and the risks of owning equities. By early May 1999, the P/E of the NASDAQ 100 index reached 81, a bond-equivalent yield of less than 1.25%.

Since the value of common stocks is the discounted stream of expected dividends, and since dividends must be paid out of earnings one way or another, the pattern of dividend yields since 1994 is instructive as well: They are approaching zero at an exponential rate.

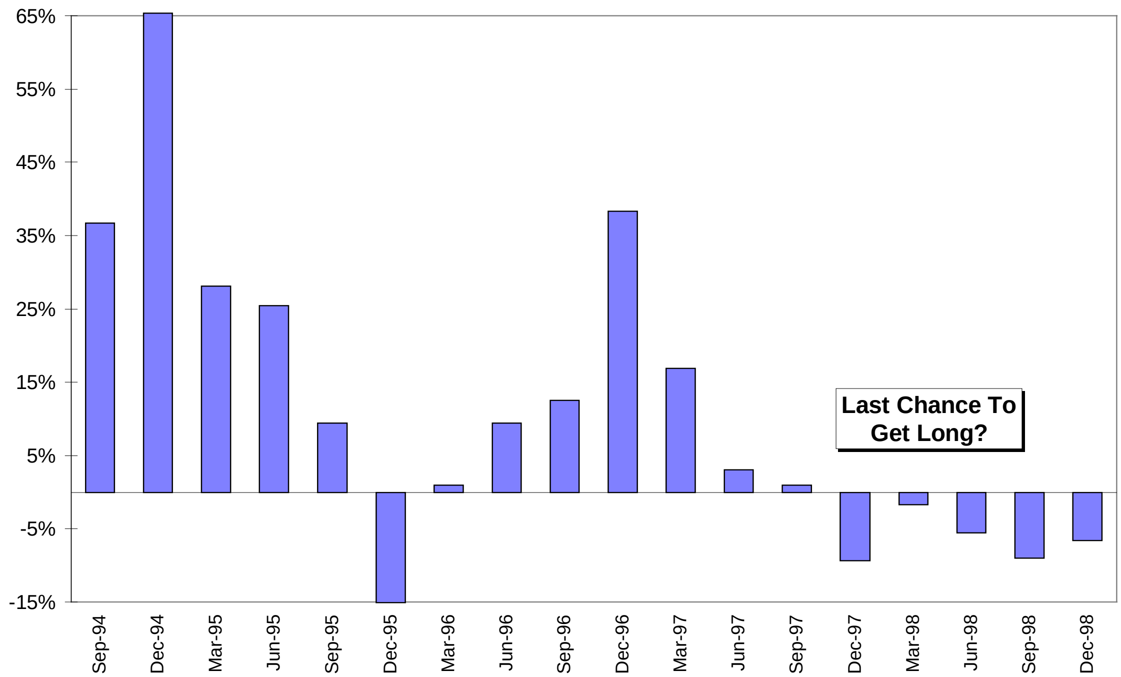
Dividends Don't Lie:
Weekly Dividend Yield On The S&P 500



While the distortions of the tax code – dividends are taxed both at the corporate profit and individual income levels – encourage low dividend payouts in exchange for capital gain potential, the willingness of investors to ignore an immediate return is disturbing. Turning a stock into the equivalent of a zero-coupon bond with growth potential is like keeping all of your winnings on the table in a poker game: One day the gains could disappear, and what would you have to show for owning the stock for a long period?

Well, not to worry. We're in a new economy, with a network server in every pot, all sorts of productivity gains, big-time earnings increases, and a lean-and-mean business culture sworn to uphold shareholder value, right? If this was really the case, then why wasn't there even one quarter with even a 5% year-over-year earnings per share growth for the seven quarters between June 1997 and December 1998? Big earnings gains occurred in the last two quarters of 1994, just prior to the start of the great bull run, but markets don't look backward, do they? They look forward, forward to the day when some Internet stock somewhere, and in our lifetimes, will embarrass itself by reporting actual earnings.

Year-Over-Year Earnings Growth



Fundamentals Are Boring, Let's Talk Technicals

The Chinese have a useful device to justify the presence of their ruler, the Mandate of Heaven. It is simple, elegant, and totally circular: Whoever is in power at the moment has the Mandate. A loss of power is both caused and demonstrated by the loss of the Mandate, which is now in the hands of the new ruler. Stock market valuations can be made equally self-justifying via our own exclusive Mandate of Ralph.

The Mandate of Ralph is based on the simple premise that there's a lot of cash out there ready, willing, and able to flow into a shrinking supply of quality equities. Whether the source is the Bank of Japan pushing interest rates toward zero, (see "A Matter Of No Small Interest," *Futures*, September 1996) or the Federal Reserve countermanding the constrictive fiscal policies of the Clinton administration, the ability to borrow cheaply always supports financial assets. Taken in combination with the intense competitive pressure felt by fund managers, (see "Games People Play," *Futures*, July 1998) the result of this monetary largesse is every dip is seen as a buying opportunity.

Spike lows, a pattern where today's low is lower than both yesterday's low and tomorrow's low, occurred on no less than 21% of the trading days between November 1994 and June 1999, inclusive. More interesting than this rush to buy, however, is the willingness to ignore common warning signals of market tops.

Spike tops, a pattern where today's high is higher than both yesterday's high and tomorrow's high, were even more common than spike bottoms, occurring 21.52% of the time. Outside reversals to the down, where today's high is greater than yesterday's high and today's close is below yesterday's low, occurred 3.03% of the time, with eight of these occurrences then establishing a spike low. Twelve key reversals, where a new high is set during the day, but the close is below yesterday's low, occurred. Still, the market has charged ahead to one new high after another.

If we can continue to advance in the face of deteriorating fundamentals and one set of bearish technical signals after another, does this mean we should drop all pretense of analysis from now until the end of time in favor of the most rudimentary buy-and-hold index strategy? Such a strategy would not have worked well during the long trading range between 1966 and 1982, a period in which no capital gains would have occurred and inflation destroyed the nominal value of portfolios.

What has been the difference between the 1996-1982 and 1982-1999 periods? Two variables stand out, demographics and politics. The advance of the Baby Boom generation into its peak savings years was accompanied by a change in government policies that, various depredations in recent tax laws aside, actively encouraged wealth accumulation by the citizenry. The demographic outlook will start to change within ten years as older Boomers start to retire. The change in politics could come at any time.

Once these two changes occur, we will find that everything we know is not wrong. It's never different this time.