Is It Safe Yet?

There is a scene from the movie “Marathon Man” where the bad guy (Laurence Olivier) asks the good guy (Dustin Hoffman) “Is it safe?”. Hoffman doesn’t know the answer because he doesn’t understand the question. Oliver, enraged at not getting a simple yes or no, decides to “fix” Hoffman’s teeth. For those of you who saw the movie, you know what happens.

Attempting to answer this question from an investment perspective, “Is it safe to invest?”, one is reminded of the inherent dangers of market forecasting.

Even though our mothers told us we wouldn’t touch a hot stove twice, now is as good a time as any to brave an answer. But first, some perspective.

One year ago, many economists predicted the Dow Jones Industrial Average (the Dow) would finish 2008 at 15,000; slightly higher than the beginning of 2008. Needless to say, the Dow is no where near that level as we begin 2009. In fact, we would need an unprecedented miracle to get to 15,000 by the end of 2010.

Nonetheless, a number of respected economic models suggest that the “fair value” for the Dow is at or above 15,000. Given economic issues, the Dow is not likely to reach 15,000 anytime soon. What these models suggest however, is that IF the Dow were trading at 15,000 today, then expectations for future returns would settle at an historical average annual rate of return (typically around 10% for the stock market).

What might you infer from this? Well, with the Dow roughly 40% below the estimated “fair value” of 15,000 (needing to rise about 70% to get to 15,000) then investors might reasonably expect a rate-of-return that is well above historical averages in coming years.

“FAIR VALUE” in this economic model represents the level of corporate profits that the government generates (based on reports to the IRS) discounted (or reduced) by the prevailing 10-year US Treasury interest rates.

This simple “capitalized profits” model suggests that the broad US equity market in America is at its cheapest level since 1953.

Put another way, the market is cheaper than it was in 1974, 1982 and 1994. Each of these years was followed by huge market increases. Will it be different this time?

Although we will very likely read about more “terrible news” (is there now any other kind?) including layoffs, foreclosures and shrinking GDP, it appears most of the intense parts of the economic tsunami are already behind us.

History shows that the stock market tends to hit bottom before recessions end. In 1974, the market bottomed in December and was up by more than 25% when that recession ended in 1975. The market hit bottom in August 1982 and was up 26% before the “recovery” officially began in November 1982.

Economics suggest the current recession should end by midyear. If this is true, then stocks have probably already bottomed.

Knowing when the recession may end is one key to this forecast. Still, one could reach a similar conclusion when considering the facts that mortgage rates have plummeted, and the “fear index” (symbol VIX) sits at well below one half of its all-time high.

What do we expect for 2009? My message to you is this; when the market is in turmoil, pay attention to risk, and invest for the long term.

In addition, in the words of Warren Buffett from October 2008, “Let me be clear on one point: I can’t predict the short term movements of the stock market. I haven’t the faintest idea as to whether the stocks will be higher or lower a month – or a year – from now. What is likely however, is that the market will move higher ... well before either sentiment or the economy turns up. So if you wait for the robins, spring will be over."

"Is it safe yet?" Oh yes. Now if you will excuse me, I've got to run.

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