

Asset Market Talk

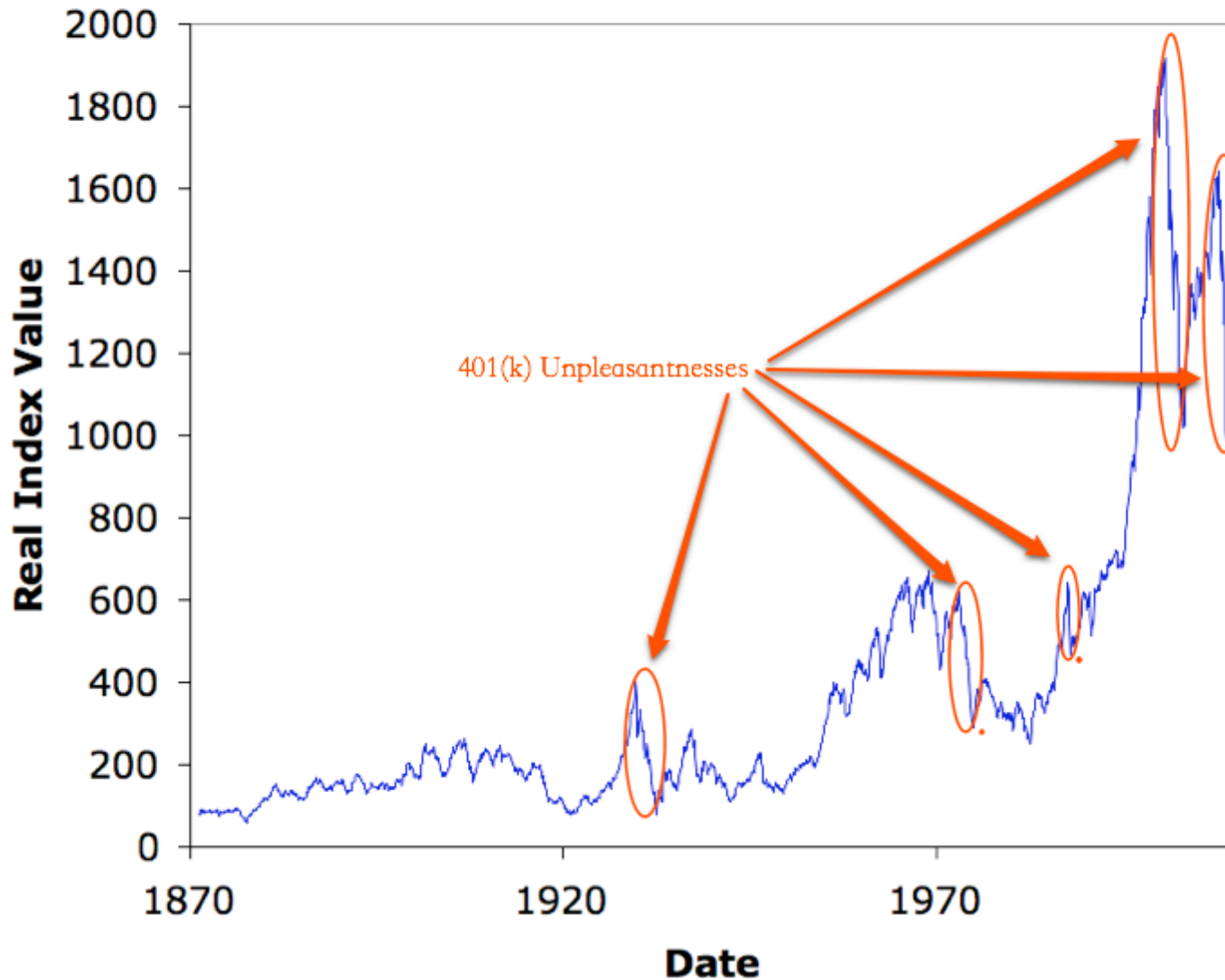
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The Stock Market, 1871-Present: Real Prices



Let's start with the stock market--and we are talking about the market as a whole: index funds, not variations of individual companies' values around market average trends...

We could also talk about the bond market, but not enough time--the bond market is like the stock market, only less so...

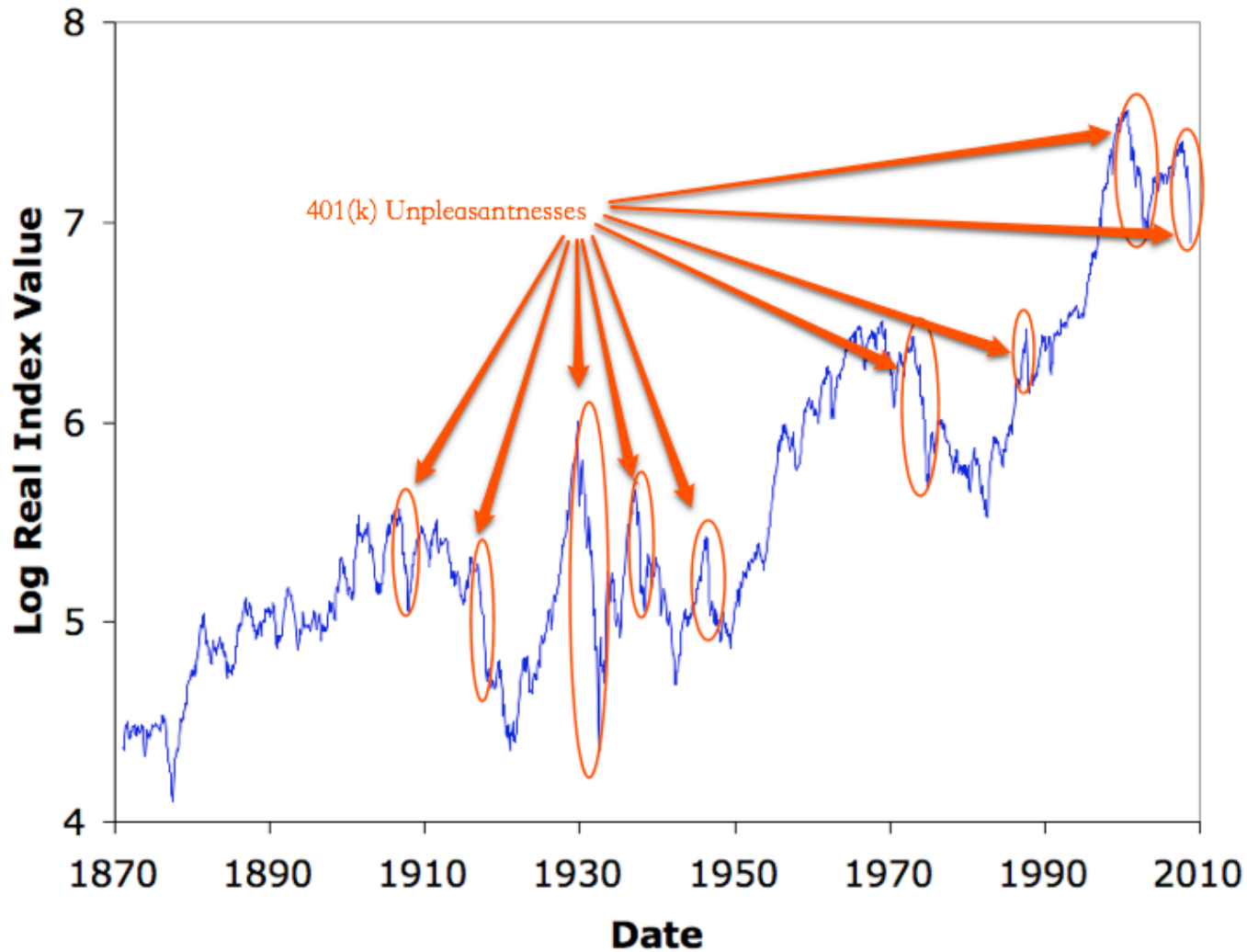
This is the S&P Composite stock index: better than the DJIA because $500 > 30$ and because it is a sensible average...

Adjusted for inflation...

Returns are high: these are capital gains, and there are dividends too...

That is, *average* returns are high: we see these events that I will call 404(k) unpleasantnesses...

The Stock Market, 1871-Present: Log Real Prices



Log scale to provide a clearer picture...

Log scale makes the unpleasant 401(k) events seem smaller--but they aren't really...

Log scale makes it clear that there are more unpleasant 401(k) events--in this century, roughly one every decade...

Still, to have two such events in one decade smacks of carelessness...

An Accounting Framework

$$(1 + r_t)P_t = D_t + P_{t+1}$$

$$(1 + r_t)P_t = D_t + (1 + g_t)P_t$$

$$(r_t - g_t)P_t = D_t$$

$$P_t = \frac{D_t}{r_t - g_t}$$

□

fluctuations in g_t —returns not predictable

fluctuations in r_t —returns predictable

One-Month Real Stock Returns 1880-2008



At a one-month horizon, returns are definitely not predictable--no how, no way...

And at a one-month horizon, risks are great...

If you are a short-term investor, return predictability is not a factor worth chasing...

Twenty-Year Real Stock Returns 1880-1988



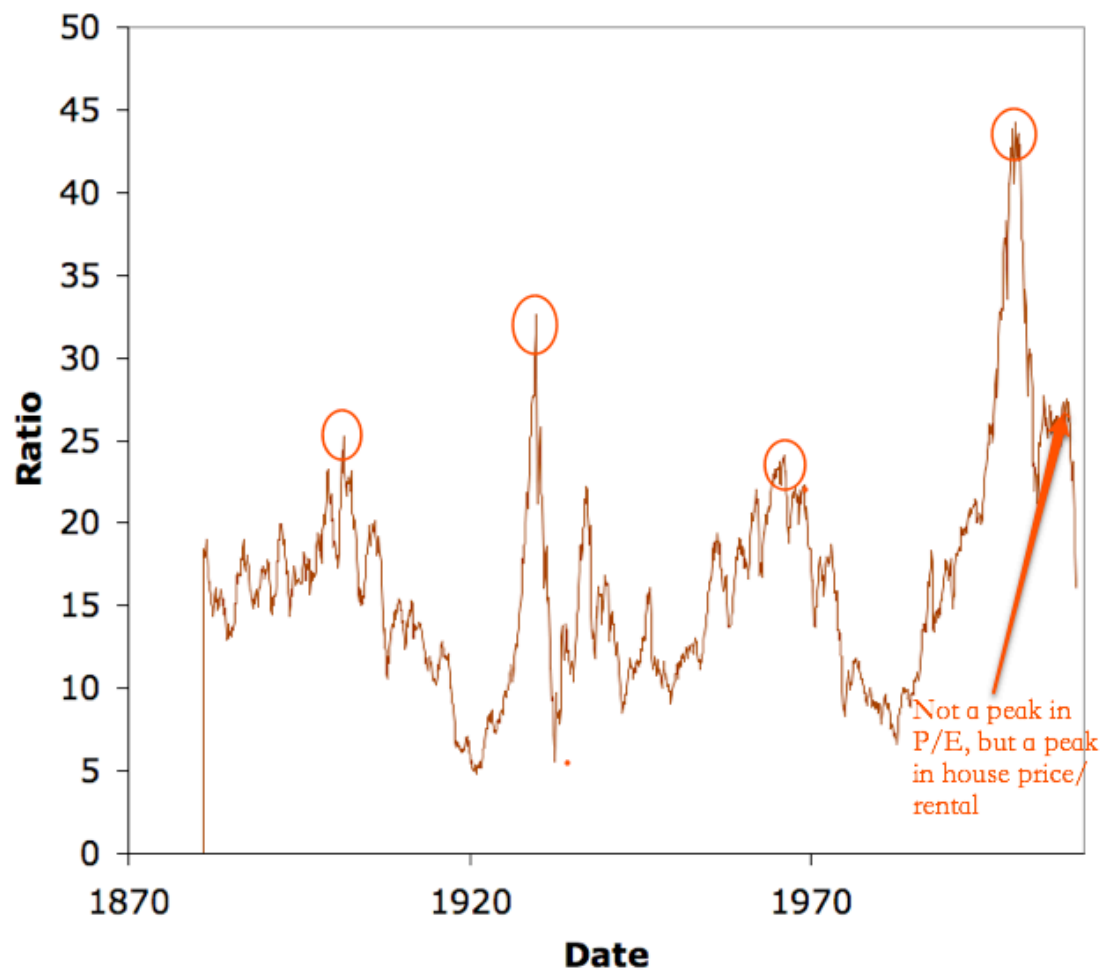
But at a 20-year horizon, returns are very predictable...

The Campbell-Shiller rule: take a ten-year moving average of earnings, and compare prices to it...

When price / 10 yr ma earnings is high, watch out...

Subtle statistical issues: on the edge of significance...

The Stock Market, 1871-Present: Price/10 Yr MA Earnings



At the peaks, expected returns going forward have to be low...

But very few stockholders at the peak interviewed think returns are low...

Infection model the best bet...

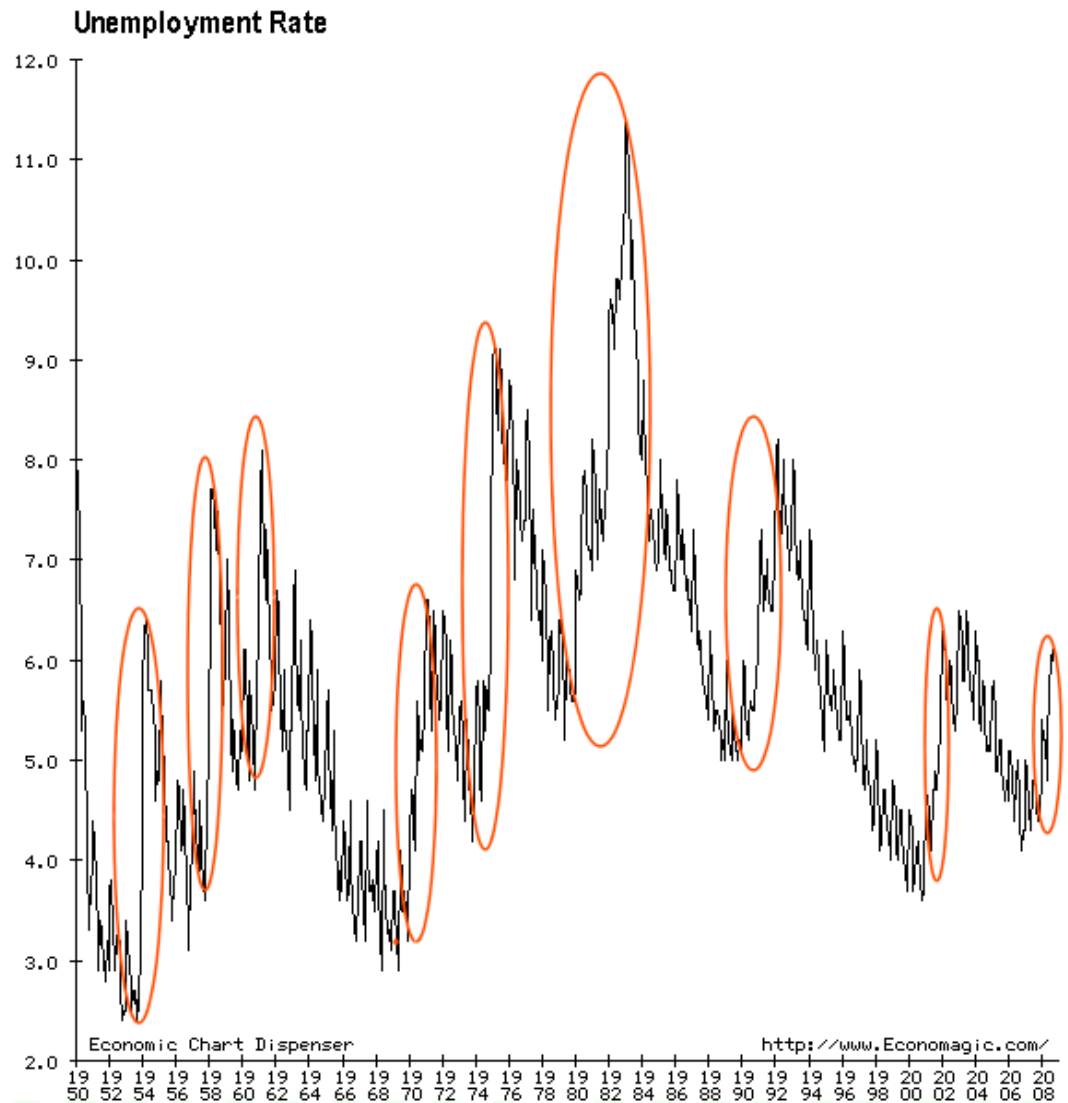
Why doesn't the market correct?

How can you make money? In the short-term you don't know when a crash is going to come, and leveraged bets on a crash are very hazardous...

In the long run--well, in the long run you are still doing as well as other, safer asset classes...

Same for housing--only more so...

Do Asset Prices Matter?



Yes, a lot, if you have a big 401(k)...

Yes, if you are running a bank or a bank-like entity...

Yes, if you are a home builder or a construction worker--there the price of real estate, of new housing, matters a lot...

For the rest, there is a puzzle: American firms shouldn't be dependent on having a high stock price in order to fund their investment spending...

Yet most times when stock prices fall an episode of rapidly-rising unemployment is on the way...