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Is it too Late to Invest?

-J. Kevin Meaders, J.D, CFP®, ChFC, CLU

July, 2014—One of the greatest minds to have ever lived—Albert Einstein—proffered the universal truth that all things, space and time included, are relative to one another. He probably wasn't thinking in terms of economics, but it would appear that relativity holds true with stocks, bonds, stars and constellations alike.

To my mind, nothing shows relativity like a good chart. According to Pearson Prentice Hall, the textbook printers, 65% of the population consists of visual learners. Let us begin with facts so obvious that a chart is not even needed, but surely tells the story.
I believe you will recognize this chart without much of a challenge: it's the Wilshire 5000 chart of our stock market since 1970, as represented by 5000 stocks rather than the 500 of the S&P 500 or the 30 mega caps of the Dow Jones Industrial Average.

This is a look of the last 44 years:

As you can see, overall it's been a great run, increasing 20-fold in forty-four years. But what dramatically stands out is that this long term run has been punctuated by two large retreats, in 2000 and again in 2008, wiping out billions of retirement dollars each time.

In both instances, stocks hit an all-time high just prior to these massive losses. Today, you can see that we are again witnessing new and ever increasing all-time highs. Quite frankly, chart spikes like this should always garner closer consideration, and indeed, scrutiny.

Many investors, who lost money in 2000, were finally tempted back into stocks just in time for the 2008 crash, and lost money yet again. It's no wonder these investors fled stocks after the 2008 crash and have never returned.

Now, in our estimation, they're looking at the market reaching new all-time highs and they're thinking, "I've missed all the run-up, and now it's too late to invest. It's going to crash again and I'm not going to trust in it. Twice bitten, thrice shy."

But I believe they've been in this mindset for years now, and even though we believe another market crash is eventually inevitable, what if it doesn't occur for another five years? And what if, during that time, the market gains another 50%? What if?

Without question, from the perspective of absolute values, the numbers are literally off the chart. But let's consider—as Einstein did—the *relative* valuations of the stock market and the overall economy: then versus now.

The first thing we need to do is to pick a couple of 'thens' with which to compare our 'now'. So let's choose January 2008 since this is just a few months before the Great Recession of 2008 began, and March 2009 which is when the market bottomed out, ultimately resulting in a fifty percent loss in stock valuations.

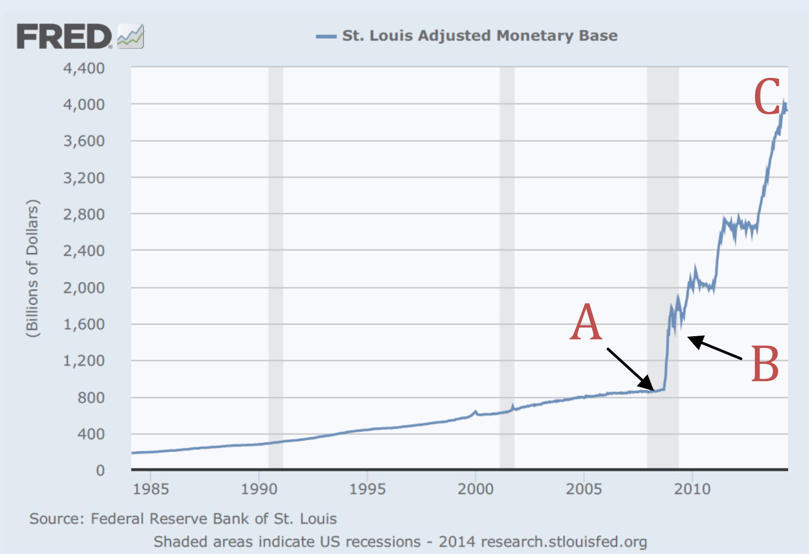
Thus, throughout this paper I have denoted January 2008 as "A", March 2009 as "B", and April 2014 as "C".

If you think back to what happened in 2008, you may remember the collapse of Bear Stearns and Lehman Brothers, and the subsequent bailing out of the remaining financial sector by Henry Paulson of the U.S. Treasury Department, and Timothy Geithner of the New York Federal Reserve Bank. Ben Bernanke took more of a back seat role, but he was certainly involved too.

The solution they came up with was called TARP: Toxic Asset Relief Program. The basic tenet of the program was to transfer any further risk of loss from the banks to the Federal Reserve, then from the Fed to the Treasury, and, of course, on to the taxpayer, or more precisely, the global dollar-user. I say global dollar-user because in the end, it is the real value (purchasing power) of the dollars being held that is robbed by the dollars being created.

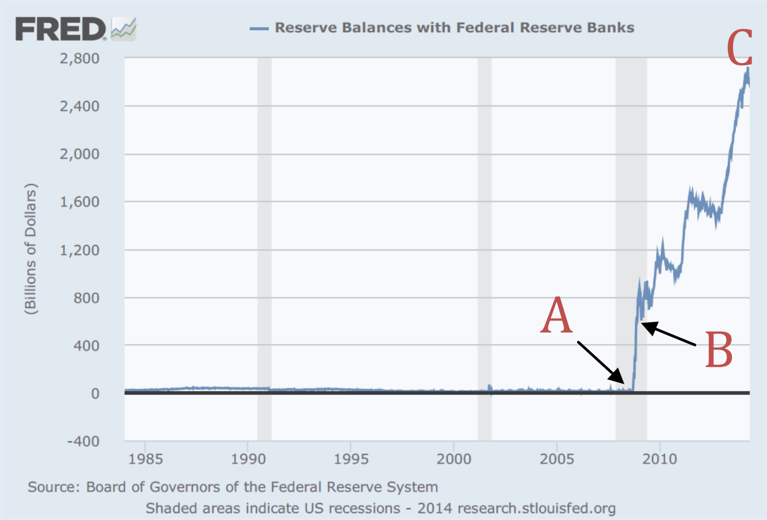
The less familiar chart here represents the Monetary Base, which is not the money in circulation, but the base amount of money that's been *created*.

Note the relatively gentle slope up until the 2008 financial crisis, when the Fed created TARP, QE1, QE2, Operation Twist, and currently, QE Infinity. Prior to 2008, our monetary base was just over $800 billion.



Note that today, roughly six years later, the monetary base is a whopping $4 trillion.

It is important to note that not all of that money has made it out into the economy. The chart to the right shows the reserves that are held by banks with the Federal Reserve. As you can see, that number is just shy of $2.8 trillion.

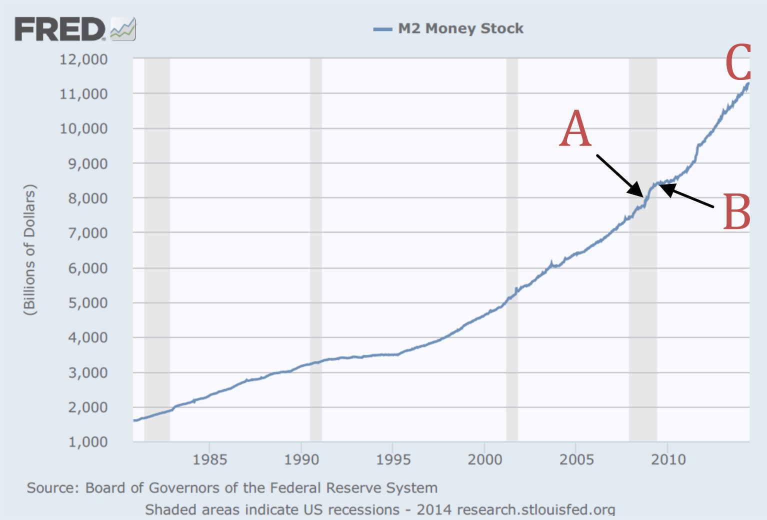


So what does this tell us?

Well, it tells us that a whole lot of money has been created since the 2008 crisis, and that the banks got the majority of that money, which they have since left on deposit with the Fed. (Ironically, because the banks have been slow or reluctant to loan out more money, inflation is much less than it otherwise could have been.)

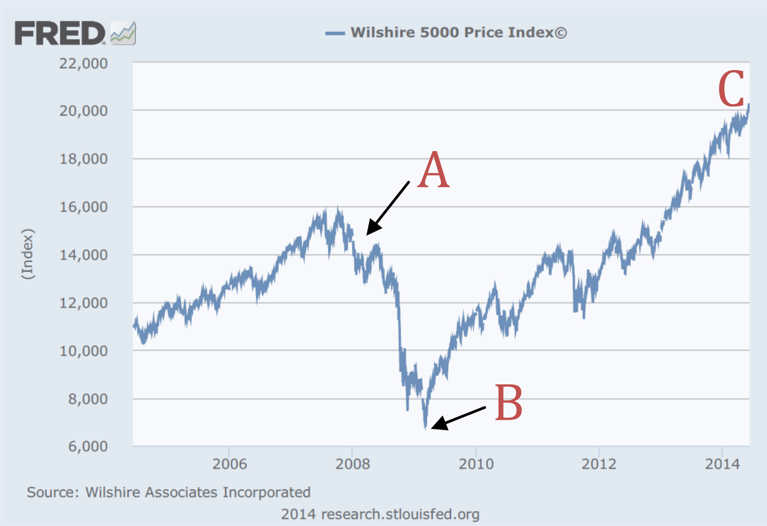
Thus, in real life terms, the financial sector is very solvent. It is difficult to see how a Bear Stearns or Lehman Brothers event could occur with liquidity like this.

The question then turns to the actual amount of money that's out in the U.S. economy today—the Money Supply (M2). The graph here shows what is now the "best" government number available, now surpassing $11 trillion.



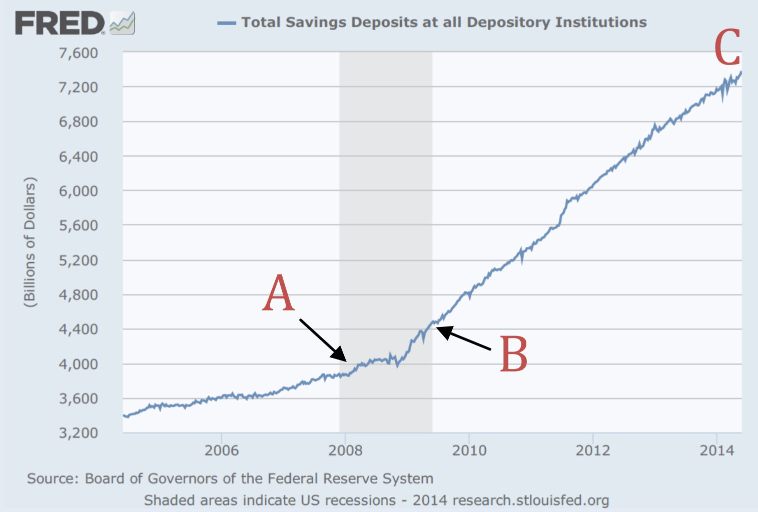
We should note that an additional $3 trillion has made its way into the economy since the 2008 crisis began.

If we now go back to the market since January 2009, using the Wilshire 5000 again, we can see that the market has more than doubled: from an absolute low near 7000 to over 20,000 today.

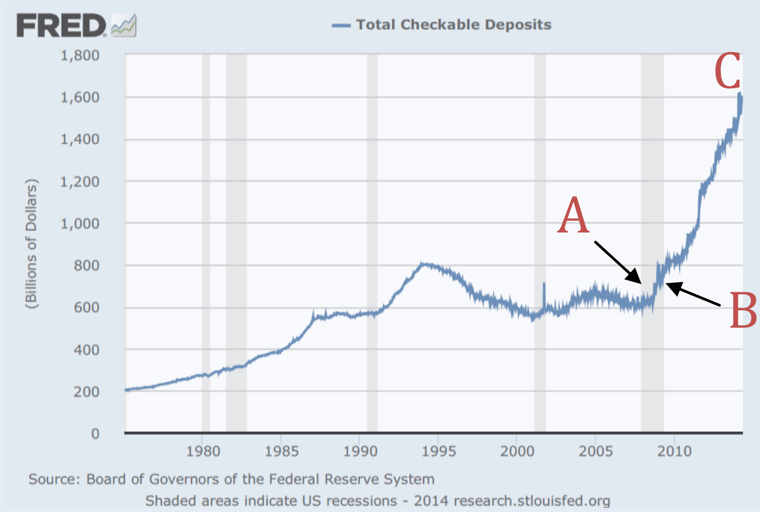


That's nearly 300%! By anyone's estimation, that's a great five-year run, which definitely gives you the feeling that the party could soon be over.

But let us now consider these two questions: (1) How much money went into the market to drive prices to almost triple? And (2) where did this money come from?

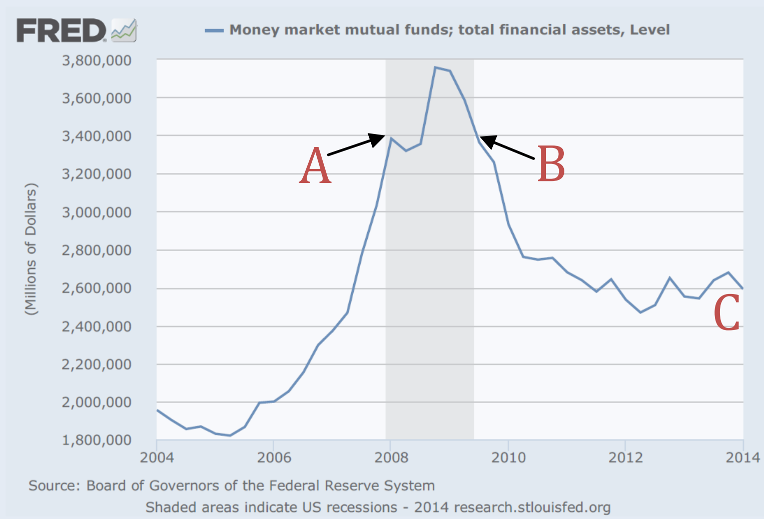


Well, we can see that it did not come from savings accounts. In fact, Americans have been piling cash into savings. The chart here shows savings accounts at an all-time high, with more than **$7.4 trillion** (!) sitting in cash, in savings accounts, earning nearly nothing.



If we look at checking accounts in the second chart, the story is much the same—an all-time high, with over **$1.6 trillion** sitting there. Again, earning practically nothing.

Ask yourself how much interest your savings account is paying these days. And checking accounts that pay interest—laughable. Remember those days? Well, you might as well forget them.



So, here we are. We've got $7.4 trillion in savings and $1.6 trillion in checking, which rounds out to a nice $9 trillion in cash, just sitting there, earning little to nothing (and actually eroding with the silent inflation that's occurring.)

Nevertheless, our markets have hit all-time highs. Going back to our two questions above, we now know where the money *hasn't* come from: savings and checking—there's more money there than ever. But you can't buy stocks with nothing; you've got to have dollars, and they must have come from somewhere.

And our third chart shows that somewhere: money markets and money market mutual funds. Unlike the other charts which have all peaked out with historic amounts of cash, we can see that money markets tell an inverse story. They peaked out during the worst of the crisis and have since diminished.

In rough numbers, we can say that money markets peaked out at about $3.7 trillion, and have since pared roughly $1.1 trillion, leaving a not-so-meager **$2.6 trillion** still sitting in money markets. This is logical because much of this money was housed in brokerage accounts, ready to be invested when the time was right, whereas savings accounts and checking accounts involve physically writing a check as well as metaphorically taking money out from under the mattress.

In any event, it *is* possible (though highly unlikely) that *all* of that $1.1 trillion went directly or indirectly into stocks, and thus has driven prices to all-time highs. Surely some went elsewhere though, such as real estate, mortgages, and the like. But let us nonetheless assume that all $1.1 trillion *did* go into stocks—does this mean that a *mere* $1.1 trillion (or so) moved the market from its low to where it is today?

It would appear so. And there's another **$11.6 trillion** *still* sitting in cash!

It's true that a good deal of investment capital has come from abroad, but this capital must have first been converted to U.S. dollars before it could have been invested in U.S. stocks, since they're all priced in dollars, and only convertible in U.S dollars.

Forbes and USA Today, among others, are also reporting that corporations have been buying back their stock with enthusiastic zeal—understandable and wise. However, the same argument holds: a company doesn't show up to buy its stock with nothing. It must first have—you guessed it—cash.

And it's also true that some of this money has made its way to the options market, which allows an option holder to control 100 shares per contract for a fraction of the share price, but depreciates over time, usually within three months, until eventually it becomes worthless or is exercised at a profit. In any event, this doesn't exacerbate prices permanently unless option buying outweighs selling unabated, which is economically impossible in perpetuity.

So now let's put it all together and consider where we stand from a 'relative' perspective, if you will kindly bear with me.

At the last all-time high, (point 'A)' in January 2008, the Wilshire 5000 was 14,753. At that time, the money supply (M2) was $7.5 trillion. Today, (point 'C') the money supply is $11.3 trillion, an increase of almost $4 trillion.

Already we've seen where $1.1 trillion moved the market more than 100%, from point 'B' to point 'C.' Is it not logical to ask: "what would happen if only *half* of that new $4 trillion made its way into the market?"

But let's not stop there. Consider the entirety of the money sitting in cash: $11.6 trillion. It's earning less than inflation, and it's been sitting there for over five years now—savings, checking, money markets and money market mutual funds.

What can be done with that money? Think about it.

Think about what you can do with your *own* money? I believe you have essentially four options: You can (1) save it, (2) spend it, (3) give it away, or (4) invest it. I think that's about it. *(You could burn it for warmth or use it as wallpaper, as history has painfully demonstrated, but here we are working under the assumption that money still has value.)*

<u>Do you want to save it?</u>

1. Savings and checking account balances are at all time highs. Interest bearing accounts are paying less than inflation. Bonds have been overbought for years now. Precious metal prices don't show commensurate demand. It may be fair to say that saving money is going out of style. These days, saving is not saving, it's losing. In fact, the European Central Bank just introduced negative—that's right—negative interest rates to further discourage cash hoarding. Can you believe it? European banks actually have to pay to hold cash with the ECB. Could this happen here?[1]

<u>Do you want to spend it?</u>

2. If a trillion or two is spent, we will gladly accept it, as most of that money will go right into corporate earnings. Corporations are lean and mean: They've laid off surplus employees and streamlined their processes since the 2008 crisis. Americans love to shop, and our corporations are more than happy to indulge us. Increased retail spending leads to increased corporate earnings, another **positive outcome**.

<u>Do you want to give it away?</u>

3. Americans are the most gracious and charitable people on the planet. If a trillion or two is given away, that money would be—you guessed it—spent, saved, given away, or invested. What would happen if you gave *your* children or grandchildren some of the money in your savings account? Exactly. It would be spent. (If not, see above.) All of these are a **positive outcome** for stocks.

<u>Or do you want to invest it?</u>

4. What else can be done with the money? No doubt it is more fun to spend money or even give it away, but despite plenty of charity or gluttony, smart money will always look for a way to re-invest. So what are the options? Not cash, not bonds, not treasuries. No, the answer is: stocks. And thus, here we are: what we believe to be another **positive outcome** for stock prices.

We believe there are very few current scenarios which call for an extended stock price depression, as you may discern from our analysis, supra. Nevertheless, one should always consider the intrinsic risk associated with investing in stocks, which includes irrational emotional market swings, sometimes triggered by geopolitical events or natural catastrophes.

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[1] Source: BBC News, June5, 2014. ECB Imposes Negative Interest Rate

In any event, our analysis would suggest that stocks may experience pullbacks between 3 and 5 percent before marching ever further. These are typical retrenchments which offer us opportunities to invest cash into the market—a market which (we believe) could continue to rise—for a time, at least.

I believe Einstein would consider it reasonable to estimate even higher stock prices based on the unprecedented hoard of dollars pent up in unemployed cash. The great professor let the math dictate his opinion, no matter how unnatural the result may have felt, or how foreign the idea. Looking at stock prices from an 'absolute' perspective—all other things being equal—I would certainly sing a different tune. But Einstein taught us that all things are relative, and history—economic history included—has certainly proven him correct, many times over.

It is my sincere hope you have found this analysis helpful. As always, please feel free to contact us to schedule an appointment with me if you'd like to discuss your personal situation. There is never a charge for an initial consultation.

About J. Kevin Meaders

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Kevin Meaders graduated from Oglethorpe University in Atlanta with a double B.A. in Philosophy and Political Science, and then obtained a law degree from Georgia State University College of Law, focusing on estate planning and trust law. He has earned the designations of Certified Financial Planner (CFP®), Chartered Financial Consultant (ChFC) and Chartered Life Underwriter (CLU). He holds a General Securities Principal and Registered Representative registration and Investment Advisor Representative registration through ING Financial Partners (member SIPC).

About Magellan Planning Group

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Magellan Planning Group was established in 2000 to provide a service uniquely tailored to the needs of our affluent Atlanta community. We concentrate on *personalized* retirement planning through tri-disciplinary coordination:

- Financial planning with our Certified Financial Planner™ to prepare a retirement plan that takes into account your needs and expectations. We are a fee only asset management firm.

- Estate planning with our in-house Attorney-at-Law to determine and prepare the documents needed to minimize family liability and maximize privacy. (www.magellanlegal.com)

- Tax planning through a relationship with our in-house CPA to manage tax obligations throughout the year and prepare a tax return that takes into account current tax laws. (www.magellantax.com)

Our relationship doesn't begin and end with the preparation of a plan and the appropriate documents. We establish close personal relationships with our clients and their families and maintain those relationships through regular 'check-ups', market commentaries and educational Lunch & Learns.

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