The 80's Mistake

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Stocks peaked in 1972, with the S&P 500 Index trading around 118 points. By the end of 1974, markets dropped 43%, making most investors petrified of equities.1979 was the year Paul Volcker became chairman of the Federal Reserve. His only mandate was to bring down runaway inflation caused by the print and spend LBJ years, and Nixon's abandonment of the gold standard in 1971. By the time Volcker was appointed, consumer inflation (CPI) was running hot with 11% annual increases. As expected, Volcker started immediately raising interest rates and by 1981, 2-year Treasuries reached nearly 17%. Similarly, 30-year fixed rate mortgages climbed to nearly 19%. Strangely enough, and at the exact same time, the stock market went on to make a fresh new high in December of 1980.

Conventional wisdom tells us to own short duration assets like money markets and dividend stocks during high inflation environments and long duration assets like longer term Treasuries and growth stocks during low inflation environments. In theory, this makes sense because future profits are discounted by risk free rates. For example, during the COVID-era when a 2-year Treasury paid 0.12%, high-octane growth companies like Peloton, Traeger, Carvana, Shopify, and a host of other names traded for unsustainable, astronomical prices. Similarly, strong cash flow and dividend producing stocks like ExxonMobil, Walmart and Procter & Gamble traded for extremely cheap multiples. Today, the opposite is true. With 2-year Treasuries now yielding around 5%, tech stocks are down, and value stocks are up…with one small catch. The trade happened in 2022, not 2023.

The reason stocks rallied amidst Volcker's inflation fight and why they haven't plummeted in 2023 is because markets are always forward looking. Many investors who experienced the equity bloodbath in the 70's wanted nothing to do with stocks in the 80's, which turned out to be an enormous mistake. As Shelby Davis of Davis Advisors pointed out, "You make most of your money in a bear market, you just don't realize it at the time." From the end of 1979, when Volcker started his aggressive rate hike campaign, to the end of the decade, the S&P 500 produced a total return of 283%, one of best periods in history to be an equity investor.

Many investors missed the 80's because they preferred double digit yields on Treasuries and money markets and ignored earnings yields on the S&P 500 Index. While cash yields started declining in the mid-1980's, earnings yields stayed mostly constant. From 1983 to 1989, earnings yields hovered around 8.5% while the real (inflation adjusted) return on bonds dropped into the 4.5% range. When you add earnings and dividend yield together, equities presented far better real returns for investors during the 80's than bonds, but many people missed out.

While money markets pay far less in 2023 than 1983, rates are much higher than they've been in recent history. Investors can make 5% risk free or buy long term bonds at what Barron's Magazine calls one of the best bond buying opportunities in history. We aren't market timers, so we aren't willing to make a short-term call like Barron's did, but we return to our core belief, that stocks are the best inflation hedge over the long run, not bonds. Yes, you can buy a money market right now at a 5% *nominal* (before-inflation) yield. However, *real* yields on money markets are a measly 1.3%! Today, earnings yield on the S&P 500 Index is projected to be nearly 6%. With dividends included, stocks should continue to compound at their long run averages of 8-10% per year. Yes, you can earn 5% risk free, but you can't eat risk adjusted returns for dinner. When inflation finally subsides and yields fall, stocks are likely to continue their upward climb. We may not earn 80's-esque equity returns, but we continue to believe total real returns on U.S. large company stocks will be two to three times that of Treasuries. Like the 80's, you may not have a chance to react to a stock market recovery. And while stocks may correct further from here, the S&P 500's current level of 4,300 points makes stocks cheaper than their 5- and 10-year averages.

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