

Mixed Emotions

The world is a mess. The world is cheap. These are the twin assertions that I wrestle with and have wrestled with on a daily basis for several months. I don't need anyone to tell me I am wrong on either account. There are ways to measure each assertion and I have gone back and forth and measured "messiness" and "valuation" from a number of different perspectives and I can confirm (in my own mind) that the world is indeed messy and cheap.

So how should investors approach this market? First the big picture. There are a number of long-term charts and figures that one can produce to show that stocks are almost certainly sitting near some kind of generational low. I can remember when I started out in this industry in the early 1990's and reading books by people like Benjamin Graham and Warren Buffett who talked about stocks trading on 8 or 9 times earnings. Ten years into my investment career I can remember thinking that I had never seen a "normal" stock ever trade on anything close to 8 or 9 times earnings. Fast forward to today and not only are we back to the 8's and 9's, I can tell you about a whole bunch of stocks trading in the 6's and 7's.

But 6's and 7's don't happen by accident. The world is a mess and these extreme valuations are symptomatic of both the severity of our problems and the likely enormity of the solutions. Greece for example is not just financially bankrupt; it is "Bankrupt" in the broadest sense of the word. The US is not bankrupt.....but it is polarized and as they head towards elections in 18 months or so no "unifying Presidential candidate" has emerged. Alas, we do have the emerging markets but our dependency on China cuts both ways. China is long overdue for a financial crisis of some sort and when it comes it's going to be a doozy. So what is one to do?

Place your bets on....human progress

The world has gone through dark periods before and one could easily argue that the previous ones were even worse than the current epoch. In economic terms, the 1930's and 1970's were the two dark decades prior to the current one which I won't date because it isn't finished yet. However, what we can say about the 1930's and 1970's is they both set in place the pre-conditions for

(let's call them) 25 year runs of reasonably strong economic growth. And when we look back we begin to realize that this occurs because it takes tough times to bring about the kind of changes that are necessary for enterprise, government and nations to move forward. The world is a mess, yes indeed and this is what human progress looks like.

Of course buying into human progress feels even better when you are only paying 60 cents on the dollar. That's in my view the extent to which this market is undervalued. However, that discount won't be resolved tomorrow or the next day. It's far more likely that this discount will be slowly resolved over the next decade and you will see it at the margin with a couple of extra percent each year. But I also doubt that the discount widens. It's possible that this market of 6's and 7's goes lower but I don't see it. Time to buy but be a patient buyer.

Final thoughts

This is the shortest newsletter that I have written in some time. I'm not usually lost for words and I am not now. However, the things that I said last quarter and the quarter before still hold true and many of the figures I could produce have hardly changed. The equity risk premium is perhaps the most fascinating as it implies that the market is not only pricing in risk but that it is pricing in an almost absurd degree of risk. This is in my view the big driver of the next rally....but the timing of when that rally comes is anyone's guess, although we are ready for it when it comes. Call me if you wish to chat – JP Donville – 416-364-8886.