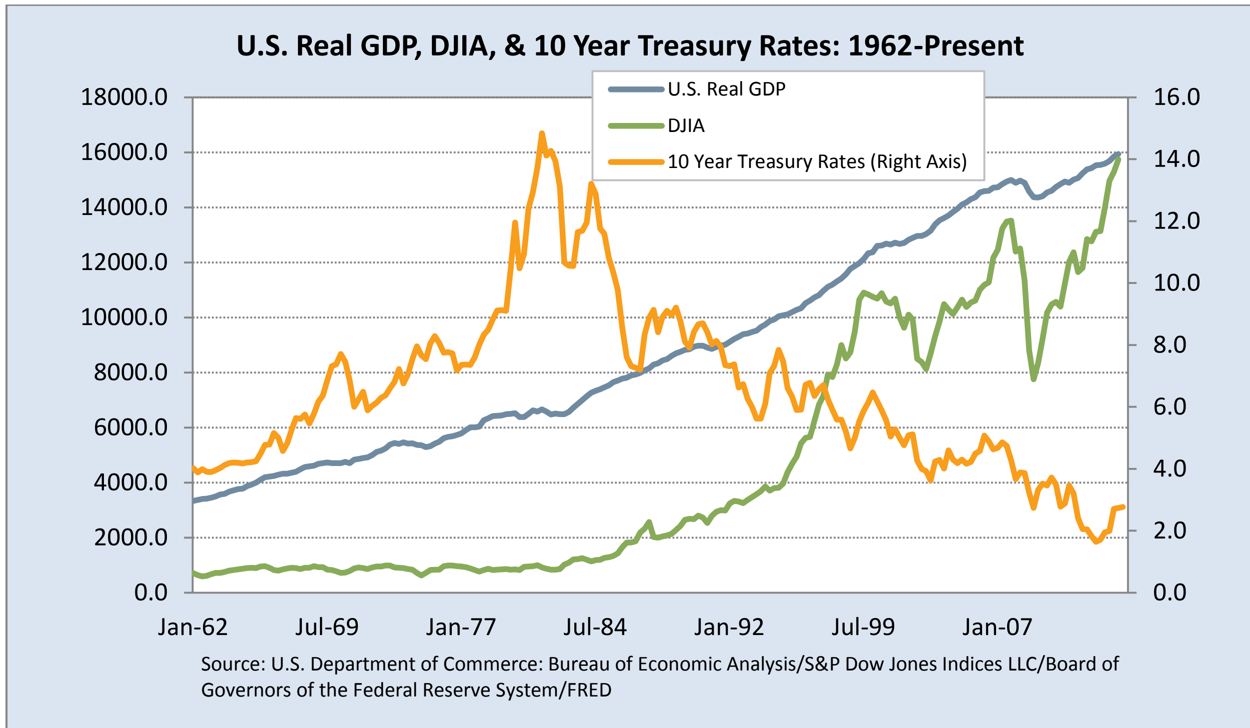
The *Investment* House LLC

The Investment House Quarterly: April, 2014

Index	Q1 2014	2013	2012
S&P 500	**+1.81**	**+ 32.39**	**+16.0**
Barclays US 20+ Yr Treasury	**+7.73**	**-13.88**	**+3.36**

Source: Morningstar

The Long View



These days, so much of our attention is absorbed by short term items: an email, a news report, an earnings announcement, a text or a blog post. Since the number and variety of media forms has proliferated, while our capacity to process them has remained the same, it is understandable that we feel a sense of growing data fatigue. What does all of this stuff mean? What am I supposed to do with it? How should it affect my decision-making, if at all?

For this reason, we think it's a good idea every so often to take a step back from the day to day chatter and to reexamine the long view about fundamental investment realities: Real GDP Growth, the level of equity prices, and long term interest rates. After all, these are the real drivers of our investment opportunities, and it is these three variables and their interactions which will largely determine the nature of our investment choices, and their likely outcome.

Looking at the graph of these three variables above – Real GDP, Stock Prices, and Interest Rates since 1962 – we can observe 3 very important themes which are useful guideposts to our overall investment strategy.

1. There is economic growth over the long term, and it has been remarkably stable for 60 years. This is through high and low inflation; wars; the resignation of a President; two oil crises; the Cuban Missile Crisis and the fall of the Soviet Union; near-constant war in the Middle East; Terrorist attacks on the U.S., Britain, Europe, and other countries; disease, famine, global warming; a world-wide financial crisis – *YOU NAME IT – the last 60 years has seen it all, and STILL, economic growth has persisted.* Human ingenuity and organization have prevailed over the chaos, albeit at times only narrowly. The blue line of US Real GDP growth has been remarkably stable and persistent, with very few bumps of any magnitude along the road.

2. The Return of US Stocks (price plus dividends) has grown with the economy, but with much more variability. The green line showing US Stock prices loosely tracks the economy, but if we were giving each of them names, we might call the economy Steady Eddy while the stock market might be Crazy Charlie. The frequency and magnitude of stock price changes is obviously many, many times that of the underlying economy. But if stock prices reflect the value of corporate earnings, and earnings are a direct output from the economy, how is it that the engine – the economy – could be so stable, and that the car – stock prices – could be lurching all over the road? Answer*: THE DRIVER*. Who is driving the stock market car along this economic road? *WE* are. And since we are human and cannot see into the future, every little bit of information we have; every fear or wish we indulge; every tip we hear or give – is immediately imputed into the prices of all assets, - most of all, stock prices. And since, fickle as we all are, these things change wildly each day, so do the prices which reflect those behavioral changes in us. So we may expect that as long as prices are affected by people, they are always going to change constantly and often wildly. But the underlying economic reality upon which they are based rarely changes nearly as much.

3. Interest Rates matter much more to the price of financial assets than do most other things. The peak of the yellow (interest rate) line was July 1, 1981. At that time, the 10 year treasury yielded 14.8%. Today it yields 2.7%. At that time, the Dow was at 909; now it stands at roughly 16,000. We can see that it was only AFTER interest rates took their second big plunge – from 13.2% in April 1984 to 7.6% in April 1986 – that corporate earnings and growth began to be reflected in the price of stocks. Why the delay? Because people naturally coming out of a high interest rate environment did not believe that the lower rates would stay. Thus, their inevitable positive effect on BOTH earnings and valuations were incorporated into stock prices only gradually, in keeping with the uncertainty. We are now almost 30 years out from that point and interest rates have done nothing but go down since then, with no evidence of their upturn in sight. Yet, at any given point along that yellow declining interest rate curve of the last few decades, many regarded a large interest rate hike as inevitable, and were sadly mistaken. What is the real truth? Neither we, nor the Federal Reserve itself, can know with any great accuracy the trajectory of long term rates. What we do know is that, if history is any guide, they will affect the price of financial assets much more than they will the underlying economy.

So, taking the long view, what do we know?

That in the U.S., economic growth has been quite persistent over time; that stock prices may vary considerably even in a strong, vibrant, enduring economy; and that the level of interest rates greatly effects the pricing and valuation of financial assets, but often with uncertain timing. And through it all we know, great investment opportunities will be created when we over- or under-react to economic fundamentals: in a world where Crazy Charlie is a stock market driver, the Steady Eddie economy will give us many opportunities, and we aim to capture some of the best of them.

The Investment House LLC ("TIH") is an investment advisor registered with the U.S. Securities and Exchange Commission (SEC).

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