ROCHESTER BUSINESS JOURNAL
RBJ
WWW.RBJ.NET
MAY 17, 2019

At this stage of economic expansion, is it like 1996 or 1999?

ON INVESTING
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In a recent interview with CNBC, famed investor Warren Buffett marveled at the current economic environment. He noted that unemployment is at multi-decade lows and the federal budget deficit is at an all-time high, yet inflation and interest rates are historically low. No economics textbook, in Buffett's estimation, could have predicted such an environment.

Such an environment shouldn't really exist, as full employment and excess government spending should result in more aggregate demand, which should result in rapid economic growth, driving up inflation and interest rates. Instead, we're seeing what some are calling a "Goldilocks economy" where growth has been solid, yet not strong enough to raise inflation and interest rates.

While not exactly the same, this sort of too-good-to-be-true economy also existed back in the 1990s. Inflation was relatively modest throughout the decade, but by 1997, it was below 2 percent. The unemployment rate was not as low as today, but certainly reasonable by historic standards. Despite that, gross domestic product growth was north of 4 percent from 1997 to 2000. This surge in growth was unusual as it occurred late in the economic expansion, which proved to be the longest on record at 120 months.

The current economic expansion is 118 months old and seems destined to set a new record. The parallels to the 1990s aren't just limited to the economy. The stock market is also partying like it's 1999, or at least 1996. Figuring out which is actually an interesting exercise.

During the decade of the 1990s, the stock market rose to unprecedented highs. Valuations soared, driven mainly by technology stocks, and even more narrowly, internet stocks. The speculative excesses of the period are well known, and the fun lasted far longer than anyone could have guessed.

In 1996, stock market valuations were already higher than any time in history except just before the Great Depression. Fed Chairman Alan Greenspan gave his famous "irrational exuberance" speech that year. Despite this backdrop, the stock market continued to rise for four more years at more than 20 percent per year.

Large-cap growth stocks dominated this impressive run. Diversification was an anchor around investors' necks, as value, smaller-company, international, and real estate stocks all lagged the incredible performance of large-cap growth. Returns for these other segments were still solid, but nowhere near as good as the largest stocks with the strongest growth prospects.

During the decade of the 1990s, large-cap growth stocks compounded at just over 20 percent annually. Large-cap value stocks earned 15 percent, small-cap stocks were around 13 percent, and international stocks and real estate investment trusts earned only single-digit returns. It seemed foolish to invest in anything other than the largest tech stocks.

Just like Buffett's economic textbook, the investment canon would suggest that this sort of environment shouldn't exist, and certainly shouldn't last a decade. After all, we're told that diversification is the cornerstone of investing and the one "free lunch" in the world of finance because it can result in lower risk and higher returns. What went wrong?

The problem was, and continues to be, that economics and finance are still largely social "sciences." There are no universal rules or truths. There are generalities, but because people are at the root of all financial transactions, irrational behavior that breaks the "rules" can result in some peculiar outcomes. The Dutch paying more for tulip bulbs than for houses during Tulipmania in the 17th century, or Americans chasing brand-new internet stocks with no earnings and few assets in the Dot Com boom of the late 20th century both seemed reasonable at the time. The prospects of selling these "assets" for even higher prices seemed almost a sure thing. Why not play the game and get rich like everyone else? In retrospect, the greater fool theory usually turns out to be a poor justification for investment.

Indeed, the first decade of the new century reversed the Dot Com trend and resulted in large-cap growth stocks losing 4 percent annually over the ten-year period. Meanwhile, other segments of the market fared relatively well. Small-cap value stocks, REITs, and emerging market stocks earned returns in line or above their historic norms.

That leads us to today's environment. While not as extreme as the late 1990s, the stock market, like the economy, seems to be out of whack. Large-cap growth stocks are again trouncing the rest of the market, led by the largest technology, or so-called FAANG (Facebook, Apple, Amazon, Netflix and Alphabet's Google) stocks.

Diversification seems antiquated. Valuations have receded a little with strong earnings growth recently, but they remain at levels rarely seen in the past. The market pullback in last year's fourth quarter seemed to mirror the volatility caused by the "Asian Contagion" in 1997. It also was a steep drop followed by a quick recovery. IPO activity is picking up, particularly among companies that have yet to earn a profit. Tech stocks continue to move higher, despite deteriorating earnings quality.

Can this continue? The answer is no, but unfortunately the timing of a change is murky at best. If we are in 1996, the good times could continue to roll for several more years. With economic growth picking up steam recently, the end doesn't seem nigh. Yet, in his recent interview, Buffet also noted that the current conditions are unsustainable for the long term.

However, if we are in 1999, things could look very different soon. When conditions changed in 2000, the scenario was ugly, to say the least. The stock market dropped more than 50 percent between 2000 and 2002. Things were more extreme then, so such a scenario seems unlikely today. That said, a significant market drop could occur at any time. Exogenous events and monetary policy risks always linger in the background.

The best way to survive when the next downturn comes? Good old-fashioned diversification. While it may seem quaint today, it generally serves investors well when they need it the most. The cliché that investing is a marathon and not a sprint, holds a lot of truth.

Chasing performance can work for a while, but it is ultimately destined to fail, whether you're buying tulip bulbs or the latest hot stock. Today's heroes inevitably will become tomorrow's villains, and vice versa. Those boring value stocks, international stocks, and REITs will likely be your best performers in the future, despite their disappointing performance over the past decade.

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