ADVISOR PERSPECTIVES

John Hussman – Why Prospective Returns Are Low

By Robert Huebscher
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Monetary and fiscal policies have driven our economy into an unstable equilibrium, pushing investors into higher-yielding securities, according to John Hussman. But those higher yields are illusory, he said, because corporate profit margins are too high to be sustainable.

"This creates an environment where stock returns prospectively are very low," Hussman said. "In fact, all returns are prospectively very low."

Hussman is the president and principal shareholder of Maryland-based Hussman Econometrics Advisors, the investment advisory firm that manages the Hussman Funds. He rarely gives interviews and almost never speaks in public, but he spoke at the Wine Country Investment Conference last week. That event was sponsored by Mish Shedlock and his firm, California-based Sitka Pacific Capital Management, as a benefit for ALS, the disease which claimed Shedlock's wife last year.

Quantitative easing (QE) has distorted market dynamics and pushed investors into riskier assets. "That is really the point of QE," Hussman said. "It is to create discomfort and cause a search for yield. "

I'll discuss Hussman's opinions on monetary policy and corporate profit margins and his forecast for equity returns.

The price we will pay for quantitative easing

The theory behind fractional reserve banking is that increasing the reserves held by banks, which the Federal Reserve does through QE, will result in an expansion of credit and lending. This expansion is thought to be proportional at a ratio of 8-to-1 to the degree to which banks are leveraged. For example, a $1 increase in reserves should result in $8 of banking lending.

The Fed's aggressive QE measures have increased the capital held in bank reserves. So why hasn't that led to increased lending?

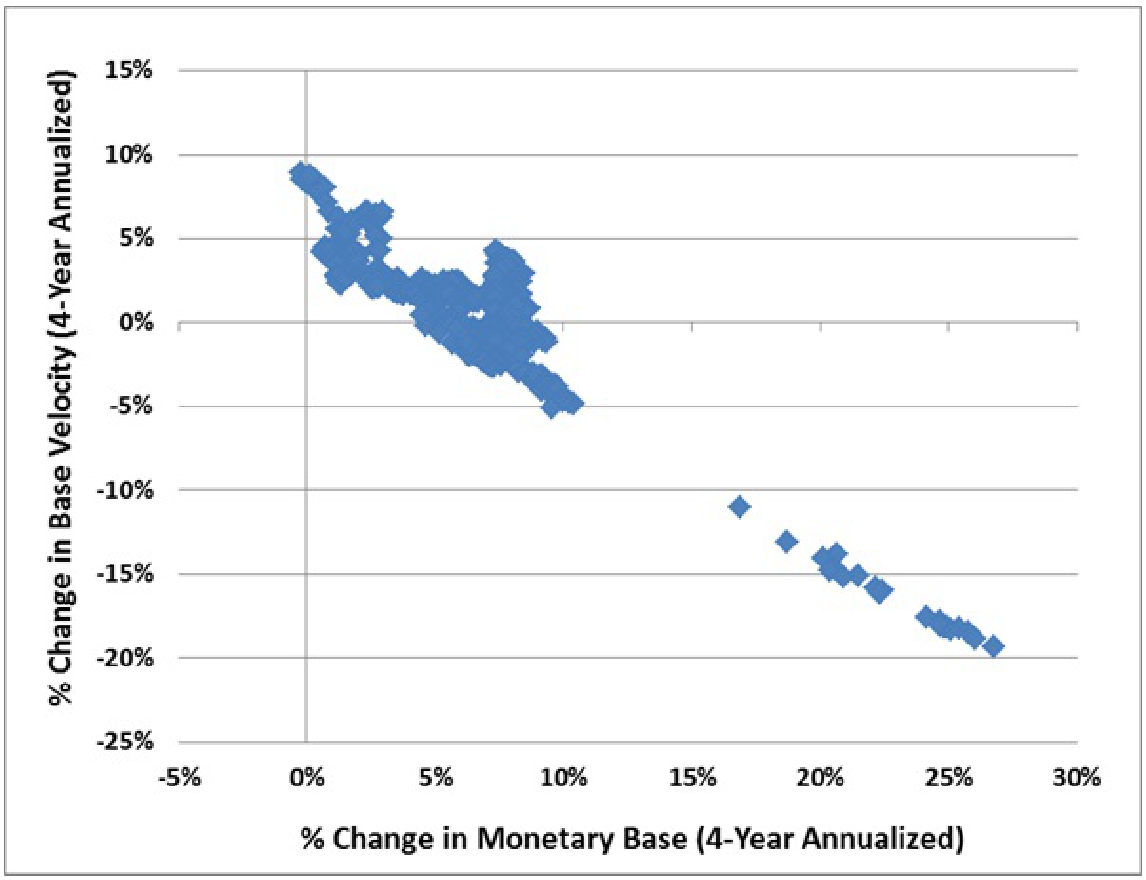
The problem, Hussman said, is that the theory "assumes away all the economic issues that matter." Our current economy lacks productive investment opportunities, borrowers who can service new debt and lenders willing to finance productive activities, according to

Hussman. Moreover, he said our regulatory environment is not strong enough to prevent lending to unworthy and unproductive speculators.

"It's as if economic activity just is generated by some change in what we do on the policy front," he said.

Indeed, as Hussman showed, QE has failed to produce economic growth.

He presented the graph below, which shows the percentage change in the monetary base on the x-axis and the percentage change in monetary velocity on the y-axis, each on a four-year annualized basis. Velocity is a measure of how fast money changes hands in the economy.



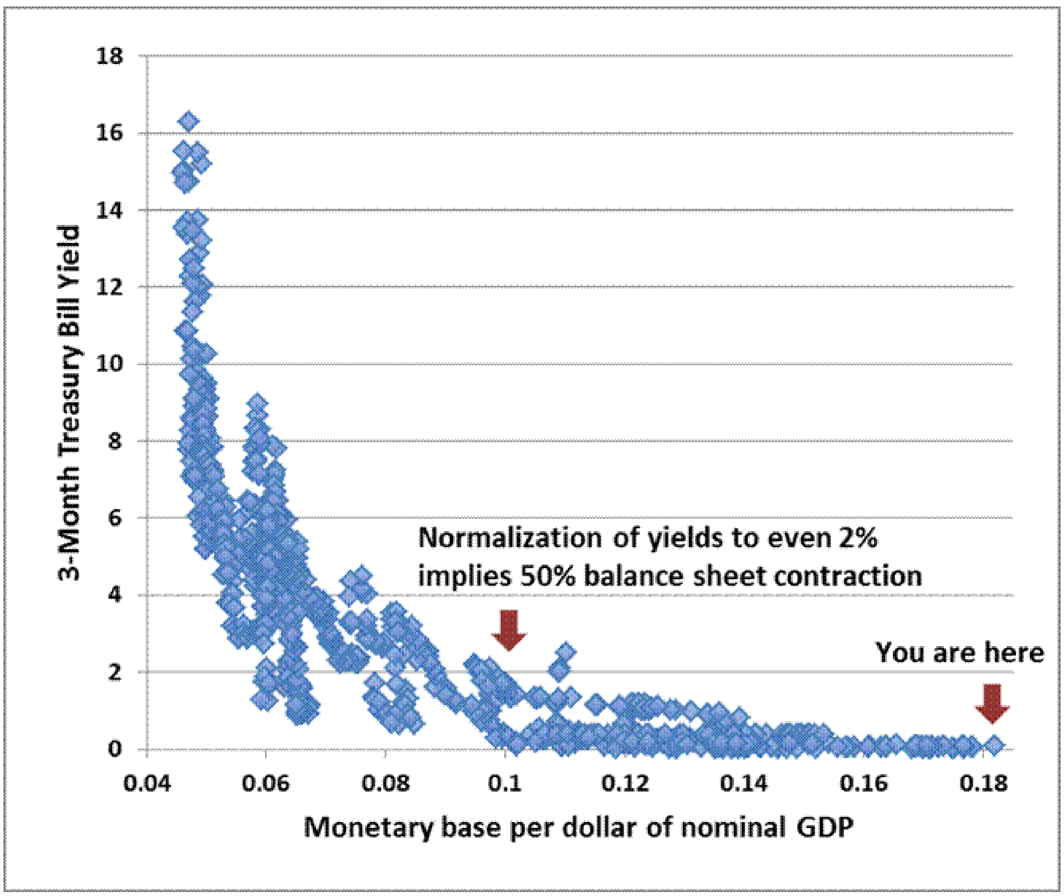
The data show that the Fed's efforts to increase the monetary base through QE have led to a linear decline in monetary velocity. Increased money supply has not led to increased lending or commercial activity.

A 6% change in velocity (the y-intercept in the above graph) corresponds historically to zero change in the monetary base. Nominal GDP has historically grown at 6%, Hussman said, and the same rate of growth in the monetary base can be accommodated without any expansion in velocity.

"There's a failure of quantitative easing to provoke durable economic growth," Hussman said. It isn't a failure of effort; it's the failure of ideas and understanding."

Without attractive investment opportunities and the ability to service debt, Hussman said, the Fed has created a big pool of money that is just sitting around.

Hussman then presented the graph below to show where QE has succeeded: increasing the demand for Treasury bills.



This graph shows data since the 1920s, with the monetary base per dollar of nominal GDP on the x-axis and the three-month Treasury bill yield on the y-axis.

As the Fed creates more monetary base per dollar of nominal GDP, investors feel they have to hold something other than cash. The next-best asset is Treasury bills, so short-term interest rates are lowered.

“This is real live economics that shows up in data, and it shows up with extraordinary robustness,” Hussman said.

At the rate the Fed is going, Hussman said it would get to $0.27 on the x-axis by the end of the year.

To illustrate the severity of the problem, Hussman said that if we stopped expanding the monetary base today, it would take 14 years of 5% nominal GDP growth to get back to 2% Treasury bill yields.

How could this situation return to normal? Hussman offered two paths. One is to contract the monetary base, and the other is to grow the nominal GDP. The former would lead to a spike in interest rates and would surely be recessionary.

The latter can happen through rapid economic growth or high inflation, ideally at a moderate rate over a long period of time. That may be hard to achieve. Hussman said our economy faces one of two “disruptive exits.” We can grow nominal GDP rapidly through high inflation, or we can endure an extraordinarily long period of slow growth, as has occurred in Japan over the last 20 years.

“It is not clear which one we’ll get, and we will probably get some combination,” Hussman said. “But it is important to understand what the dynamics of what the Fed is doing.”

Unsustainable profits

“We've got this distorted unstable equilibrium,” Hussman said. “In monetary policy, we have created an ocean of zero-interest money that somebody has to hold. That's a hot potato and encourages a search for yield.”

The reach for yield throughout the fixed-income markets explains why yields on Treasury bonds, investment-grade and high-yield bonds and other credit-sensitive debt are at historically low levels, he said.

Equity prices have also been driven up, because investors have been tempted by the illusion of higher yields on stocks. That is the result of unsustainably high profit margins, which are now 70% above their historical norms.

Household savings rates are at their lowest level in history, according to Hussman, and the government is running a deficit of 7% of GDP. Depressed spending in those two sectors has directly resulted in a surplus in another sector – record corporate profits.

Hussman offered another way to think about this. Wages as a percentage of GDP are at their lowest level in history. The result is higher corporate profits.

The historical norm for corporate margins is approximately 6%, but today they are above 10%.

Hussman said that high profit margins have been historically correlated with lower subsequent profit growth. Today's level of profit margins could correspond to a 12% annual contraction in profits over the next four years.

"That seems absurd, and yet it is a reflection of the fact that the deficit of one sector has to be the surplus of another," Hussman said. "If we are going to contain the deficits of the household and government sectors, we will end up containing the surplus of the corporate sector."

The implications for asset returns

Looking at this data, what does Hussman think is the likely return over the next decade?

One way to answer that question is to use the so-called Fed model, Hussman said. Many pundits, including Alan Greenspan, have said that the equity-risk premium is very attractive now. Equity risk premia can be calculated by subtracting the 10-year Treasury bond yield from the earnings yield on equities. Or it can be obtained by adding the dividend yield to the historical nominal growth rate of GDP, which is approximately 6.3%.

That model produces forecasts of equity returns roughly in line with historical data – between 8% and 9% annually. But the problem, Hussman said, is that the model is very unreliable. Measured statistically, it has a low (23%) correlation to actual equity performance.

Hussman's preferred way to forecast equity returns is using Shiller's cyclically adjusted price-to-earnings (CAPE) ratios. That model smoothes earnings over a full business cycle, using 10 years of historical data. Shiller's CAPE said that stocks were "reasonably valued" in 2009, Hussman said, and were likely to produce returns of 10% annually over the ensuing decade.

But this isn't 2009. At today's levels, Hussman estimated that stocks will average approximately 3.5% annually over the next decade.

We may be closer to 2000 or 2007 than most investors would like to acknowledge. The conditions today are “not too dissimilar” to those at the two most recent market highs, according to Hussman.

Hussman did not mention that Shiller’s CAPE model has never been tested over a period of extended quantitative easing, as we are currently experiencing. It may be that Hussman’s assertion that QE will push investors into higher-yielding securities will remain true and will buoy equity performance, despite what the CAPE model would otherwise predict.

Shiller’s CAPE model has a 90% correlation. “Which model do you want to use? I would be compelled to follow methods like this,” Hussman said, referring to the CAPE model.

“The good news is that will change,” Hussman said. He advised against moving out stocks and taking an extremely risk-averse position.

“My hope is that you will evaluate your own risk tolerance and then set your portfolios appropriately,” he said.