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Beyond the Rate – Chapter 11

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 11 and we'll be discussing the future of stock valuations, based on the same demographic model we used last time to predict the future of interest rates. And a summary of this model is posted on my website, by the way. It's on the 'downloads' tab and it's called the MEICAP Model.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

Please note that the text versions of these podcasts are now available (in PDF format) for free download at my website at www.beyondtherate.com along with a bunch of other related materials and resources. You can also sign up for my monthly email newsletter at that website.

Okay. So we described the basis of the model in Chapter 10 but I think it worthwhile reviewing it briefly here. The basic concept is that people go through a predictable pattern of spending and savings throughout their lives and these patterns are all well documented by the US Census Bureau. In fact, we can see the same patterns by looking at our own lives and the lives of those around us.

Between the ages of 15 and 24, the average person spends more than they make, resulting in negative savings. Between 25 and 63, the reverse is true. The average person makes more than they spend, resulting in positive savings. Then, after age 64, the average person again goes back into a negative savings stage and they stay there for the rest of their retirement years. If population levels were consistent across all age categories, this pattern wouldn't be particularly significant. But that's where it gets interesting.

The fact is that our population isn't consistent across all age categories. After World War II, we had a surge in birthrates resulting in a disproportionate

concentration of people who are all a very similar age. It's called the Baby Boom. Today, these people are mostly in their late forties and fifties and their children make up the Echo Baby Boom. Although the Echo Baby Boom isn't nearly as disproportionate as the original Baby Boom, it's still a very large group of people and they'll have their own impact on financial markets as they grow older.

Anyway, it makes sense that when the Baby Boomers were between the ages of 15 and 24, they caused a tremendous drain of investment capital because they were all in a stage of negative savings and were drawing down savings accounts (mostly from their parents but also through borrowing money themselves). The resulting shortage of investment capital within the economy caused interest rates to rise. Well, it also caused P/E ratios within the stock markets to fall.

So what's a P/E ratio? Well, a P/E ratio is a comparison of a stock's price to its earnings. Basically, when you buy a stock, you're buying a small piece of a company; a company that earns a profit. So essentially, you're buying a piece of that company's earnings. The question is: how much are you willing to pay for those earnings? You see, the stock market is an open market with buyers and sellers bidding against each other all the time to buy and sell stocks. In fact, the stock market is one of the truest examples of Supply and Demand. When there are more buyers than sellers, the price goes up. When there are more sellers than buyers, the price goes down.

Think about it. If there was tons of investment capital out there; if everybody had a ton of cash, the price you'd have to pay for the earnings available would increase. If there was a shortage of investment capital, fewer people would be trying to buy those stocks and the price would drop. Well, during the 70s and early 80s, there was a shortage of investment capital and the prices people were paying for stocks (and therefore earnings) were dropping. In other words, the P/E ratios during those years were going down.

Now, does that mean the entire stock market was going down? Not necessarily. The economy was growing during those years as a huge pool of young people was entering adulthood, spending money. When the population grows, the economy grows as well. Everybody has to buy food and gas and shelter. Everybody spends money. So the more people who are out there spending money, the bigger the economy gets. And as the economy grows, the total earnings companies make – profits – also rises.

So just because the P/E ratios are drifting lower, it doesn't mean the stock market is going down by the same proportions. What's really happening is that people aren't paying AS MUCH for the earnings of companies as they would've in different times. Well, that's exactly what was happening during the 70s in the stock markets. For the most part, the Dow Jones was going sideways for most of the 70s but the P/E ratios were coming down during that entire time, to the point where P/E ratios came all the way down to 8 or so by 1980. That means people were willing to pay 8-times earnings for an average stock at that time.

Well, since then, the Baby Boomers started entering their positive savings stage and the pool of investment capital started growing. In fact, it's been growing ever since, at least until 2003. And as the pool of capital grew, people were willing to pay MORE for the earnings of companies. In other words, the P/E ratios started rising. Meanwhile, the economy continued to grow as the population grew and spent more money. So there were two phenomena going on at the same time. The total amount of earnings in the economy was growing and people were willing to pay MORE for those earnings. The result was a bull market that started in 1982 and only came to an end in 2000.

Now, why would the stock market peak in 2000 when interest rates only reached their low in 2003? Well, there were a few reasons for that. For starters, people are affected by fads. In the late 90s, the stock market was on fire and the dot.com bubble was quickly inflating. Everybody was pouring money into the stock market. In fact, they were putting a larger percentage of their total savings into the stock market BECAUSE it seemed like an easy way to make a profit.

Generally speaking, people put more of their money into the stock market during their earlier years and then, as they get older, they start shifting their money into more conservative investments like bonds. So it makes sense that the peak in the stock market would come sooner than the peak in the bond markets. Remember that the "peak" in the bond markets means interest rates are at their LOWEST. And the stock market bubble just accentuated that pattern.

Everybody poured their money into the stock market at the expense of the bond market. That kept interest rates a little higher during those years but nobody noticed because the stock market was going up like crazy. By the way, the P/E ratios had gone all the way up to about 30 by the year 2000, even higher during certain short-term rallies. Then, it reached a breaking point and people started to panic. This is typical in the stock market because people can buy and sell so easily. Everybody's trying to sell "at the top" and if a panic begins, everybody tries to sell all at the same time. And of course, that massive selling pressure accelerates the decline and the market crashes.

As you know, during 2001, the stock markets kept going down, down, down. At the beginning a lot of people tried hanging on, waiting for the market to rebound. But as the year dragged on and the selling pressure persisted, more and more people gave up and sold their stock, pushing the markets further down. And when they sold their stocks, where do you think they put all that money? I mean, they didn't just keep the cash in a drawer somewhere, right? They had to put it somewhere.

Generally speaking, people put the money into two different places. First, they bought real estate. House prices had already begun going up because of the surplus capital in the economy and people saw it as a safe haven compared to the volatile stock market. Secondly, they shifted their retirement funds into the bond markets, lowering interest rates. Well, not surprisingly, the lower interest rates

fueled the housing markets because the same monthly payment could support a more expensive house ... and the bubble started inflating in the housing markets.

Now, the nice thing about the housing market is that people can't buy and sell so quickly. There also isn't any other new safe haven people can escape to if the housing market moderates – which is already happening. Between those two factors, I don't expect a "crash" in the housing markets. As I mentioned in Chapter 10, I believe the markets will see modest appreciation through 2012 and then go sideways for about 15 years as the pool of investment capital shrinks and interest rates rise.

So what will happen to the stock market? Well, unfortunately, we're already in that sideways trend in the stock market. Yes, it may go up and down, depending on economic conditions but I don't believe the stock market will make significant advances until about 2020. That's right, I'm sticking my neck out on this one (as anyone does when they make predictions) but I think the Dow Jones won't make any big moves upward for a l-o-n-g time.

After 2020, the Echo Baby Boomers will start putting their early life savings into the stock market and a new long-term bull market will begin. But the returns during that bull market won't compare to the sorts of returns we saw in the late 90s. And when it happens, people will be looking back at the financial boom we've all been a part of and shake their heads that more people didn't cash in when they had the chance. Yes, a lot of us have. But a lot of us missed it too.

Now, we've all heard the "experts" tell us that over the long-term, stock market returns have been significant for decades. They say the same about real estate. Why would it ever change? It's been that way for 100 years, they say. Well, you have to understand that these macro economic trends are all driven by population. As the population grows, so does the economy. And as the economy grows, wealth is created – right – SAVINGS are created. Well, those savings represent the pool of investment capital that we've been talking about these past two chapters. When the population is growing, people are making money.

Well, the population of this country – and the population of the entire world – has been growing like crazy during the past 100 years; MUCH faster than it ever grew before. A lot of that had to do with oil and the availability of energy. We'll talk more about that in Chapter 15. But most people agree that the population of the world can't grow in the future nearly as fast as it HAS been growing in the past. In fact, some people believe the maximum "human carrying capacity" of our Earth is about 7 billion, and we're somewhere around 6.5 billion right now.

Here in this country, based on current fertility rates, I believe the population will start to level out around 335 million. Right now, we're sitting around 295 million, so we're getting close. Ask yourself why George Bush wants to find a way of keeping all the illegal immigrants in this country. Ask yourself why he wants to start a "guest worker program". Think about it. There are plenty of economists

that can tell you that a growing population will fuel a growing economy. And in a democratic society, a growing economy equals jobs and jobs equal votes.

Take a look at Japan. They've got a major problem over there because nobody's having any kids. In another decade or so, they'll have the largest percentage of their population over the age of 65 of any major developed nation. And that spells trouble for their economy. Right now, the Japanese government is aggressively promoting kids and is even considering tax credits for families who have children. They know what's coming.

And by the way, why do you think Japan's had such a rough time the past 15 years or so? Well, after World War II, most of the western nations had a Baby Boom. During the exact same time, Japan had a Baby Bust. There was a lull in birthrates and that population vacuum started taking its toll on the Japanese economy around 1990 and their stock market reflected it. All these things have population in common. All these things begin with the number of people in your economy and their age profile.

Now, am I saying there's no money to be made here during the coming 15 or 20 years? No, I'm not. But the money will be made in different ways. It will be made by following specific industries or market segments. I believe more attention will focus on automated trading systems and the index funds that are currently gaining favor over mutual funds. Eventually, the two will intersect and we'll have ETFs (or exchange traded funds) that follow specific trading parameters. I believe those will be exciting times but it will take an increasingly savvy investor to find consistent profits.

I also believe money will flow to the countries whose populations are still growing; countries like India and China. It's already happening. All ships rise in a rising tide and the opportunities for easy profits will only exist in those countries that are still seeing significant population growth. That's what we've had here for the past 20 years but I believe those days are over.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 12. We'll be looking globalization and currency values. With a massive trade deficit and a falling US Dollar, inflation is inevitable

and that's a major wild card for interest rates, house prices and financial markets here in America. It's fascinating stuff. Stay tuned.

Bye for now.