

DOW 36,000 OR 3,600?

Gunfight at the OK Corral

March 14, 2000 -- Tucson, AZ. Whither the Dow? was the question of the hour at the Bank Securities Association annual meeting at high noon in Tucson today. In a financial version of the fabled gunfight at the OK Corral, James K. Glassman, co-author of “Dow 36,000” and David L. Smith, author of the *Cyclical Investing* newsletter squared off with radically opposing views of the future of the Dow, cited as a proxy stocks in general. At the time of the debate the Dow and the NASDAQ were trading around 10,000 and 5,000 respectively.

Glassman (for many years a columnist for the *Washington Post*, who currently writes a financial column for the *Reader's Digest*) argued for a leap in the Dow to 36,000 over the next 3 to 5 years, **basing his case on two critical assumptions:**

1) The present value of the projected stream of dividends from Dow stocks typically adds up to far more than the present value of interest payments on the Treasury's bellwether 30-year bond. Even though the Dow's dividend yield is hovering at near record lows around 1.5%, by Glassman's calculation the compounded growth of these dividends will produce a stream of distributions that far outweigh the present value of interest payments from the same amount invested in Treasury bonds.

2) Statistically, according studies by Ibbotson and Associates, stocks are no more risky in the aggregate than bonds over long holding periods.

If the risks are equal, Glassman reasoned, then the present value of distributions ought to be equal. The only reason they aren't, according to Glassman, is that investors cling to “outdated perceptions” of stocks as more risky than bonds. As that “irrational fear” dissipates (presumably in no small measure thanks to his best-selling book), enlightened market forces will equalize the present value of distributions from stocks and bonds, eliminating the “irrationally low perennial undervaluation” of stocks, says Glassman. In fact, Glassman attributes the phenomenal rise in stocks over the last 18 years to just such enlightenment by a growing number of investors.

Assuming constant long-term Treasury bond yields around mid-1999 rates of 5.5%, Glassman calculates it will take a rise in the Dow to around 36,000 over the next 3-5 years, to reduce dividends as a percentage of stock investments to the point where equal investments in stocks and bonds will pay investors distributions of equal present value. Once parity of long-term returns is established between stocks and bonds, Glassman foresees either tranquil “meadowlands” or a volatile “jungle” for stocks. In the meantime,

Glassman believes investors can “buy and hold” stocks without fear as the Dow climbs toward a “perfectly reasonable price” of 36,000 by 2003 to 2005.

Smith, a 30-year investment veteran, newsletter writer and lecturer, using an analogy from craps, countered that Glassman was “making his point the hard way,” observing that “a lot of weird things” have to happen in order for the Dow 36,000 scenario to unfold as Glassman projected:

- Price-earnings ratios of 100 for Dow stocks would not be uncommon according to Glassman's own calculations. Such ratios would be unprecedented, compared to a historically “normal” ratio of 14, and today's unprecedentedly high current P/E ratios for the Dow of 22 and the S&P 500 of 32, considered by many to reflect severe overvaluation.

- Likewise, the Dow would pay out dividends at the unprecedentedly low rate of around 0.5%, compared to the historical norm around 3%.

- In addition, by reaching 36,000 somewhere between 2003 and 2005, the Dow would have grown at a compound rate of more than 17% for a 21-to-23-year stretch, something that has never happened. Glassman was unperturbed by these variations from historical norms, claiming in his book and lecture that such norms were too low, reflecting perennial undervaluation of stocks due to the “outmoded misperception” of stocks as more risky than bonds.

“The fatal flaw in Glassman’s argument,” Smith observed, “is that he assumes there is *only one way* to equalize the projected streams of cash distributions from stocks and bonds -- namely, for stock prices to rise so as to reduce the present value of the future dividend stream per dollar invested until it is equal to the interest stream from bonds. *He doesn’t consider the alternative, namely for interest rates to rise, so as to increase the present value of the future interest payment stream until it is equal the dividend stream for stocks.*” (!)

“By increasing the value of the stream of interest payments through higher interest rates,” Smith pointed out, “you get to the same place -- parity in the present value of distributions of stocks and bonds -- without the weirdness of P/E multiples of 100, current dividend yields of only 0.5% and three-to-five more years of 25% appreciation piled on top of the 18 years of 15%-plus compound gains we have seen in stocks since 1982.”

Using Glassman’s own arithmetic, Smith showed how the Treasury 30-year bond interest rate would have to rise from the constant 5.5% assumed in “Dow 36,000,” to only 6.4% in order to equalize the present value of distributions from stocks and bonds. At this point, according to Glassman’s logic, it is either “meadowlands” or “the jungle.” Above 6.4%, Smith showed that the present value of the revenue stream from bonds exceeds that of stocks, which by Glassman's reasoning would prompt investors to bail out of stocks in favor of bonds. “That has already happened,” Smith pointed out, “when the long-bond yield topped 6.7% in January 2000! Not surprisingly, the Dow has been falling from its record high just over 11,700 ever since. Welcome to the jungle,” said Smith.

“For stocks to rise to Dow 36,000 you have to believe things will happen that have never happened before,” Smith summarized, “whereas long-bond interest rates rising above 6.4% would be a routine event, reflecting the usual cyclical pattern of rising interest rates late in an economic expansion that causes stock prices to peak and then decline, as recent events in the stock market appear to be confirming. Apply ‘Occam’s Razor,’ when forced to choose between two competing hypotheses, the simpler of the two is more likely to be true, which should lay the fantasy of the Dow 36,000 Theory to rest,” Smith said..

Smith went on to build his case for Dow 3,600, citing numerous “clouds in the silver lining” of today’s “Goldilocks economy,” that could derail the stock market, including:

- Soaring U.S. trade deficits that could cause international investors to dump dollars and dollar-denominated investments, as occurred in Mexico, Asia and South America in recent years
- Increasing dependency on imported oil in a tight global oil market that could prompt a reprise of higher oil prices, inflation and crashing stock prices seen in the 1970’s
- Heavy consumer debt burdens that could force consumers to trim spending, dragging the economy into recession
- A self-aggravating panic in an overvalued stock market that could drag down the economy through the “loss-of-wealth-effect”

“Regression to the mean” and a return to more normal levels of valuation in terms of stock prices relative to earnings and dividends would place the Dow around 5,000, according to Smith. “Excesses to the upside are usually compensated for by excesses to the downside as greed turns to fear, producing panic,” Smith observed, “consequently a 3,600 Dow seems like a perfectly reasonable proposition.”

“All of the usual warning signs are in place,” Smith said, listing his “Top Ten Signs of a Bull Market Peak” in David Letterman fashion.

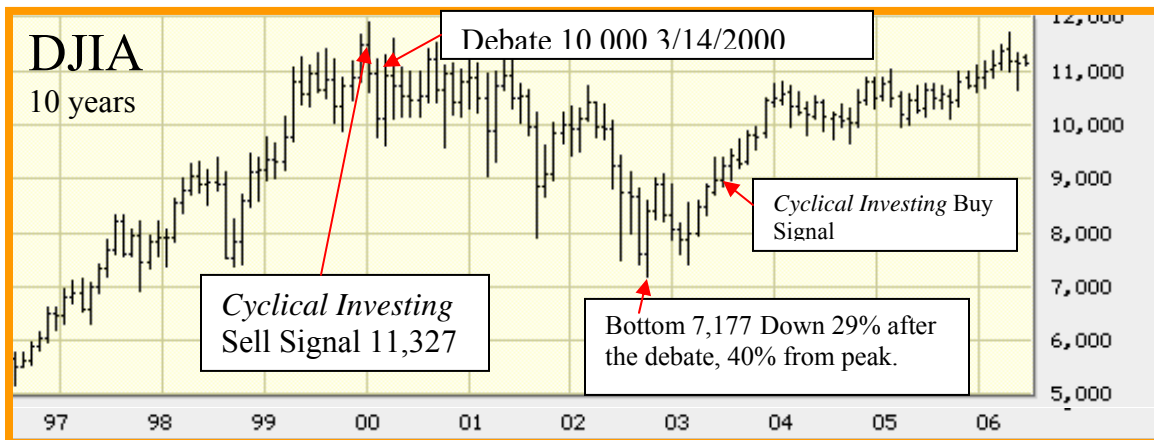
10. High volatility
9. High margin debt
8. Mergers and IPO frenzy
7. “New chips” outperform “blue chips”
6. Greed rampant, overvaluation ignored
5. “Newbies” entering the market
4. Parabolic surge in stocks after a long climb
3. Thriving economy and optimistic expectations
2. Technical breakdown prompted by rising interest rates
1. “This time it's different” rationalization

“It is for good reason that Sir John Templeton called ‘This time it’s different’ ‘The four most expensive words in the English language,” Smith added. “People fall back on ‘This time it’s different’ to rationalize their desire for continued gains in the stock market, even at irrationally high levels of valuation, at which point, the party is about over,” Smith concluded.

STOCK MARKET PERFORMANCE AFTER MARCH 14, 2000

Postscript to the "Gunfight at the OK Corral" between David L. Smith and James K. Glassman on March 14, 2000:

At the time of the debate, the Dow Jones Industrial Average had fallen from a record intraday high just over 11,908 in January 2000 to around 10,000, while the NASDAQ was trading around 5,000, two days after its all-time peak of 5,132. For the record, Smith had issued a sell recommendation to his *Cyclical Investing* subscribers on January 4, 2000, at 11,327 on the Dow and just over 4,000 on the NASDAQ. After the debate both indices plunged for the better part of 3 years, with the Dow establishing a double bottom at 7,177 in October 2002 and 7,397 in March 2003. The corresponding bottoms for the NASDAQ were 1,108 in October 2002 and 1,341 in March 2003.



In short, instead of climbing to 36,000 over the next 3 to 5 years as Glassman had predicted, the Dow lost 40% of its value from its all-time peak and nearly 30% from the time of the debate, bottoming at 7,177. The NASDAQ, however, plunged 78% after the debate from around 5,000 to an intraday low of 1,108. Had the Dow suffered the same percentage loss after the debate as the NASDAQ, the Dow would have bottomed at 2,200. So Smith's notion of Dow 3,600 as a proxy for stocks in general was right on the money.

PPS:

Those attempting to ascertain what revisions, if any, Mr. Glassman has made in his central thesis in view of the deterioration in the stock market after March 2000, will be disappointed to find that www.dow3600.com was "under construction" as of February 2002 and more recent attempts to reach the site have resulted in "Cannot find server" messages.

Smith's investment newsletter, *Cyclical Investing* celebrated its 22nd year of publication on July 4, 2006.

In its article of January 31, 2002, *The Economist* states:

Others have taken the notion [of equities outperforming bonds] to wacky extremes. In 1999, another popular book, "Dow 36,000", [James K. Glassman] predicted that the Dow Jones Industrial Average would nearly quadruple in three or four years (it is now around 9,800, and thus about where it was three years ago). Though the book's author has since, ahem, revised his target date to, maybe, "the end of this decade", he remains unrepentant about his core thesis: whether shares are cheap or dear at current prices, they are the safest way to guarantee long-term wealth. Books by others bid the target up still higher: "Dow 40,000", for one, and "Dow 100,000", a \$25 volume now discounted at \$7.50.