

[Navigation Bar \(Menu\)](#)

A New Era for Stocks?

Table of Contents

- [The Myth of the New Era](#)
- [The Reality](#)
- [Fifteen Year Growth Rate](#)
- [Fifteen Year Constant Dollar Growth Rate](#)
- [Unprecedented Growth](#)
- [Other Time Frames](#)
- [Charts of Other Time Frames](#)
- [Summary](#)
- [Demographic reasons](#)
- [Acknowledgements](#)

[Downloads](#)

The Myth of the New Era

Many have argued that we are entering a "New Era" for stocks. Typically, these arguments revolve around the baby boom saving for its retirement, and they often project 15% to 20% annual growth rates until 2007.

"We're facing 25 years of prosperity, freedom, and a better environment for the whole world."

Wired, July 1997
Peter Schwartz and Peter Leyden

"...it will mushroom into a very strong period of growth between late 1998 and 2007 when the third and largest wave of baby boomers comes into its peak spending and durable goods buying and the next generation of 25-year-olds simultaneously enters its initial spurt of durable goods buying."

The Great Boom Ahead
Harry S. Dent, Jr.

The bullish case for stocks was summarized in a **Dow Jones Money Management Alert** [interview](#) with a well-established portfolio manager. We have withheld the name. What is important is that he manages large accounts (\$500,000 minimum) and we believe his comments reflect the consensus view.

Some excerpts from the interview:

He's predicting a bull market for at least five years - 10 if conditions don't change dramatically.

"It's a wonderful time period that's going to last for a while," he says. "We won't experience anything like this again."

His prediction is based on the influence of Baby Boomers who continue to pour their incomes into mutual funds, which in turn drives up the prices of stocks. XXXXXXXXXXXX expects the bull market to turn bearish when the Boomers begin drawing on those investments rather than adding to them.

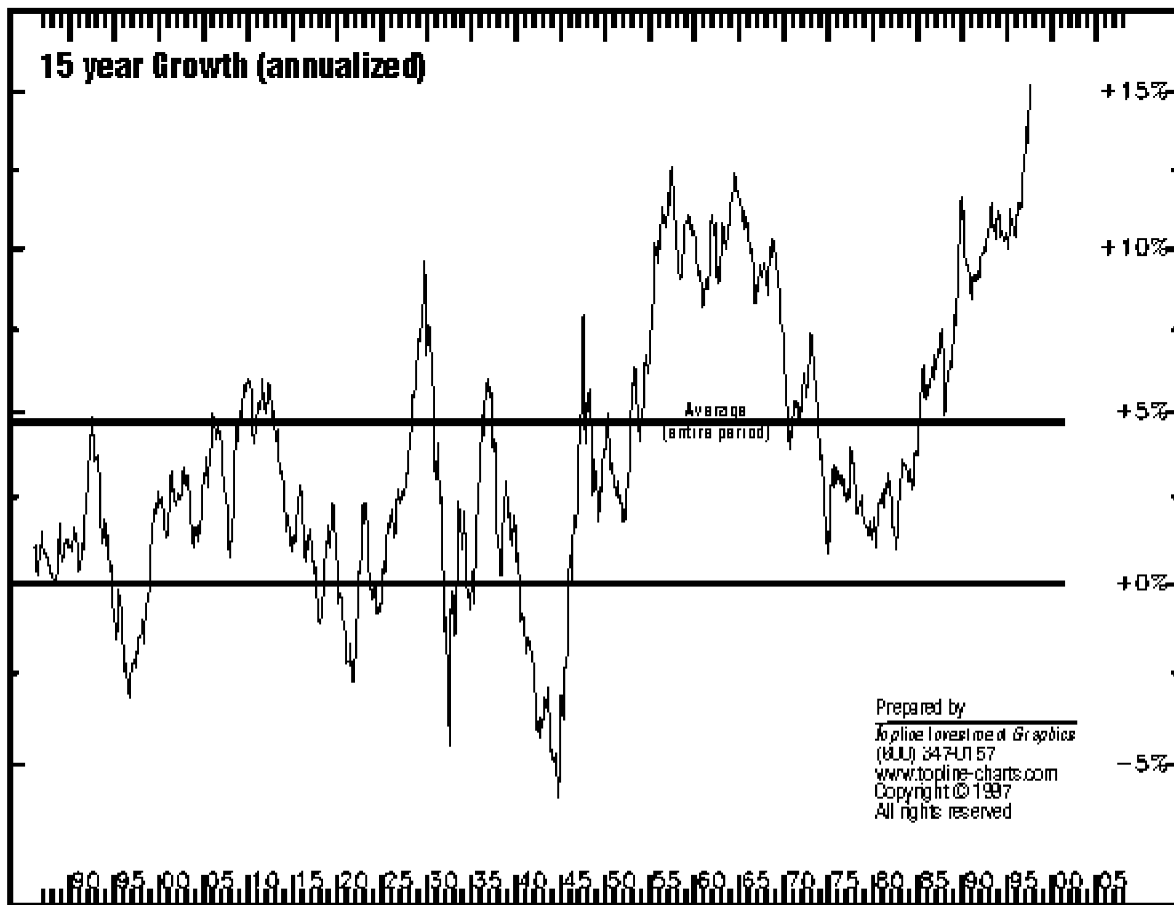
DOW JONES MONEY MANAGEMENT ALERT
David Weidner

The Reality

As this chart shows so dramatically, July 1997 ended the **first fifteen year period in history** to experience 15% annual growth in stock prices. In fact, if you examine the entire period from January 1871 through August 1997 (preliminary average), the average annual growth rate was only 4.28% (upper horizontal line on the chart). The reality of the price action is that we have **already experienced the effects of baby boom saving**. [There are sound demographic reasons for this.](#)

The charts and text on this page examine rates of return in the stock market using data back to 1871. The results may be quite surprising.

Fifteen Year Growth Rate



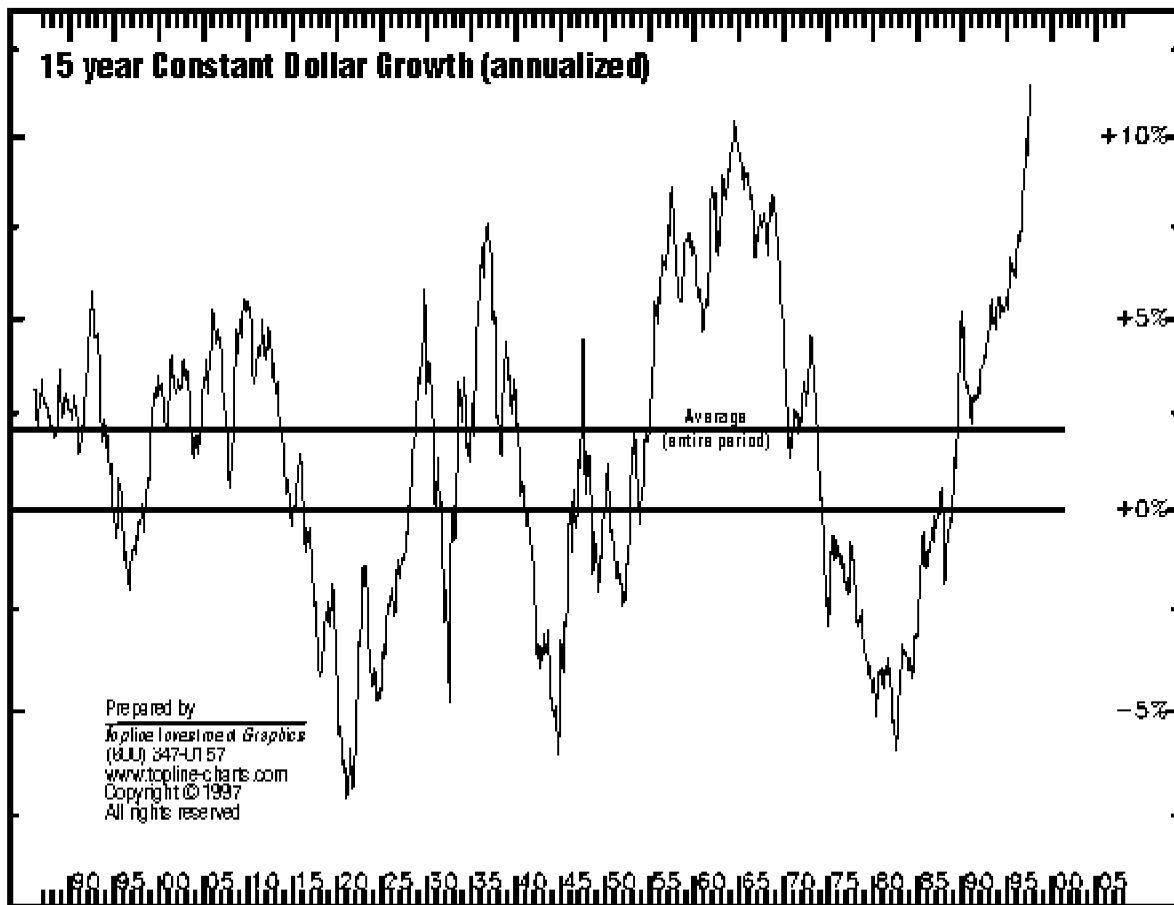
This chart shows the 15 year growth rate of the S&P 500, using monthly average data. We have spliced the Cowles Commission average on so that the can show over a century of data (raw data starts in 1871, the first 15 year change is 1886). The growth is based on price appreciation only, dividends and inflation are not accounted for.

Is Inflation Distorting the Picture?

A New Era for Stocks?

It could be argued that the the spectacular results of the last fifteen years are overstated by inflation, since the chart is based on current dollar stock prices. The next chart shows the same study based on the constant dollar S&P 500.

Fifteen Year Constant Dollar Growth Rate



This chart shows the 15 year growth rate of the constant dollar S&P 500, using monthly average data. We have spliced the Cowles Commission average on so that the can show over a century of data (raw data starts in 1871, the first 15 year change is 1886). The constant dollar S&P 500 is adjusted for inflation by dividing by the Consumer Price Index. The most recent value of CPI is carried forward (since CPI is released after the fact). Prior to 1913, annual CPI figures are interpolated to monthly values. The growth is based on price appreciation only, dividends are not accounted for.

Unprecedented Growth

As both of these charts demonstrate, the U.S. stock market has experienced the largest growth rate in over a century during the last 15 years. The forecasters

predicting 15% annual growth in stock prices until 2007 have their eyes firmly planted on the rear-view mirror. They're doing what most forecasters do – extrapolating the most recent trend .

Other time Frames

Some might argue that these charts are distorted by the time period chosen. After all, the 1982 low was 15 years ago. We have examined four shorter time periods ([charts below](#)) with similar results. They are summarized in this table:

	Annualized Growth Rate			
	Nominal		Inflation Adjusted	
Period	July 97	Average (Entire period)	July 97	Average (Entire period)
12 months	43.66%	4.23%	40.44%	2.13%
31 months	31.60%	4.27%	28.07%	2.14%
81 months	17.75%	4.78%	14.57%	2.44%
10 years	11.55%	4.35%	7.78%	1.90%
15 years	15.30%	4.71%	11.53%	2.08%

July 1997 witnessed extremes in growth in all of these measures. The annual growth rate was over *ten times average* .

Notes: There are two other myths of conventional wisdom that are destroyed by this table.

1. **Dividends don't matter.** Most studies of the long-term total return of stocks place it somewhere near 10% per year. Notice that less than half of that figure is due to price appreciation. *Compounded dividends account for over half of the long-term total return of stocks.*
2. **Market timing doesn't matter in the long run.** Note the different values for the averages in the table above – up to half a percent. The only difference is the starting date of the period being measured (example below). Buying at a different month *over 100 years ago* accounts for the different averages.

The price data that we used starts in January 1871. That meant that the first 12 month growth rate that we could calculate was January 1972. The average 12 month growth rate in the table above is the annualized growth from January 1972 to August 1997 (using a preliminary monthly average).

Why these time periods?

Because they correspond to important lows, giving the best picture of the current extremes. We're looking at stock prices back to 1871. If the current readings of these rates of change are extreme when compared to that large history, the examples really are extreme, not just carefully selected.

Charts of Other Time Frames

Ten Years

81 Months

31 Months

12 Months



Summary

After surveying these five periods of growth (ten charts), it is clear that we have experienced growth rates in stocks (both nominal and adjusted for inflation) that are so high as to be either unprecedented or very unusual.

New Era: Myth or Reality?

To assert that stock market growth will continue at present levels for the next ten years *requires* the belief in a New Era. There is simply no historical precedent for that assertion. In addition, the foundation of the arguments for a New Era for stocks rests on demographic arguments that we have found do not work. The Saver/Spender ratio (which has worked in the past and in Japan) argues that we have already seen the bulk of stock market growth due to demographics.

Are We There Yet?

This series of studies doesn't claim to be able to forecast what month the stock market will top. It does supply ample evidence that any sustained growth at these levels from here would be unprecedented. Records are made to be broken (witness the 15 year growth rates), but it happens rarely, and sustaining record-setting levels is even more rare. While we can't say that we are at a long-term top, the evidence suggests that we're getting very close.

Demographic reasons

Conventional Wisdom

Most of the demographic arguments for stocks as an investment assume that the first wave of baby boomers kids that's about to turn 25 is a positive influence for stocks. They're buying houses, cars, and paying for all the costs associated with children. The conventional wisdom is that all that spending fuels the economy, and results in rising stock prices.

Demographic Reality

We have found that ***the population of 25-34 year olds is a negative influence on stock prices.*** [That has been true in Japan](#) (with their entirely different age distribution) and in the U.S. in the past (see Encyclopedia, chart V29I, for a chart overlaying the Saver/Spender Ratio on the constant dollar DJIA from 1900 to 2050).

Why Doesn't all the Spending Strengthen the Economy?

First, because they don't spend that much. 35 to 44 year olds, 45 to 54 year olds and even 55-64 year olds spend more per capita. Second, because they are big borrowers.

This age group (25 to 34-year-olds) certainly spends almost all of their income. In fact, they typically incur a large debt load at this age. That's why Stan Salvigsen used them as "Yuppies" in his Yuppie/Nerd ratio (25 to 34-year-olds divided by 45 to 54-year-olds). *As the number of Yuppies increases, their borrowing puts upward pressure on interest rates.* Nerds, on the other hand, have the highest per capita income (half again what Yuppies earn), and more importantly, have the highest per capita net savings (roughly double that of 35 to 44-year-olds or of 55 to 64 year-olds, and over five times that of Yuppies). Those savings add money to the pool of bids for all financial assets, not just the bond market. Historically, savers approaching

retirement tend to become more risk averse, and to focus their incremental savings on bonds, increasing their influence on interest rates. That's why the Yuppie/Nerd ratio is such a good long-term forecaster of interest rates (see Encyclopedia, chart V29j, for a chart overlaying Moody's Aaa Bond Yields and the Yuppie/Nerd ratio from 1900 to 2050).

Borrowing by 25 to 34-year-olds adds supply to the bond market, draining money from all financial assets. Our research has shown that while 45 to 54-year-olds affect the demand for bonds, 40 to 49-year-olds have more of an effect on the demand for stocks. We first noticed this in the Japanese numbers, and were quite pleased to see that it also worked for the U.S. stock market.

Acknowledgements

"Original thought is like original sin: both happened before you were born to people you could not have possibly met."

Fran Lebowitz

- [Jim Bianco, CMT](#) of Arbor Trading wrote a piece for his clients pointing out how dramatic the growth in the stock market was. Also, we have spent many hours examining the demographics of markets.
- Jim's piece was followed by Ed Hyman's (ISI) chart of the 31 month rate of change of the S&P (back to the mid-1950s), which caught my graphically oriented eye and interest.
- Ian McAvity, CMT, wrote a marvelous piece in issue 598 of [Deliberations on World Markets](#) in which he examined the premise of assuming that current growth rates can continue.

This piece would not have been possible without the assistance of Jim Bianco and Ian McAvity, for which I am very grateful.

John Carder, CMT

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- [15 year growth \(two charts, 146 kb\)](#)
- [10 year growth \(two charts, 142 kb\)](#)
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