Fourth Quarter 2012 Commentary

Happy New Year! We wish you and your loved ones a happy, healthy, and prosperous 2013.

The year that just passed was one marked by seemingly relentless uncertainty. Political uncertainty with frustrating gridlock in Washington in an election year. Geopolitical uncertainty with unrest in the Middle East. Economic uncertainty with sluggish economic growth in the U.S., a recessionary environment in parts of Europe, and slowing growth in China.

Amid all this, the stock market ignored those market pundits that forecast gloomy returns and advanced healthily during the year. The S&P 500 registered gains of 16.0%, while the Dow Jones Industrial Average was up by 10.2%.

What Does GDP Growth Say About Stock Market Returns?

In the current environment we are often asked, "How can you invest when there is so much uncertainty in the world?" Our answer is always the same: "The world is always uncertain. We get worried, not when everybody is afraid of ongoing uncertainty, but when people are overly complacent. That is when there is still uncertainty, but people *think* there is none."

The past year amply demonstrated that stock market returns are not necessarily correlated to either economic certainty or even economic health. To explore this issue further, we analyzed past stock market returns versus economic growth to see if a correlation existed.

Before we give you our findings, let's start with a quiz. Below are five numbers, labeled A through E, which represent real (i.e., after taking inflation into account) GDP growth in the United States for certain years since World War II. The numbers in the right column, those labeled V through Z, represent the return for the S&P 500 index for those same years. Your job is to match the GDP growth numbers with the S&P returns. In other words, does the (3.1)% decline in GDP shown in A match the 5.5% rise in the stock market shown in Y? Or perhaps the 22% decline shown in X?

Real GDP Growth	Total Return for S&P 500
A. (3.1)%	V. 25.9%
B. (0.6)%	W. 52.6%
C. 1.8%	X. (22.0)%
D. 1.9%	Y. 5.5%
E. 7.7%	Z. 23.7%

source: Bureau of Economic Analysis, Standard & Poors, NYU

Some of the very best and worst years are represented in the above table. The (3.1)% decline in real GDP was the very worst on record. The (0.6)% decline shown in B was the fourth-worst, and the 7.7% gain shown in E is the second-best. We picked C and D, because their 1.8% and 1.9% growth rates, respectively, are not too far off from many pundits' expectations for 2013.

We also note that, in the right column, the total gain of 52.6% for the S&P 500 index shown in W is the single largest one-year gain on record.

The Lesson Is … That There Is No Lesson

But what's the answer to the quiz? Which GDP growths match up with which S&P returns?

To find the correct stock market return for each of the five GDP growth scenarios presented, simply draw five straight horizontal lines from the left column to the right column. That is, A matches with V, B matches with W, …. and E matches with Z.

In other words, the S&P 500 returned 25.9% during the year in which we experienced our absolute worst GDP growth, which by the way was 2009. Also, the S&P 500 returned 23.7% during the year in which we experienced our second-best GDP growth (1951). Two completely different economic conditions, one of the best and definitely the worst, and yet the stock market did just about the same thing in both years.

What about the nearly identical GDP growth rates shown in C and D? C refers to 2002, and D refers to 2007, and both are not far off from some economists' projections for what to expect in 2013. However, stock market investors lost 22.0% of their money in 2002, yet earned a return of 5.5% in 2007.

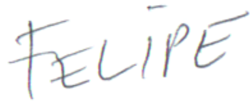
Look again at the best year for S&P 500 returns on record, the 52.6% shown in W. The U.S. economy that year actually contracted by 0.6% in real terms, and yet we had the best year for stocks. This result is rather remarkable since these figures correspond to the year 1954. If you go back and look at newspapers for that year, you will only see uncertainty with the rise of communism and turmoil in South East Asia, eventually leading to the Vietnam War. Who would have wanted to invest in the stock market in that year? The wisest, it turned out.

Ignore the Investment Forest — Just Focus On the Trees

In our recent holiday newsletter, we wrote about how unwise it would be to try to divine future stock market returns based on the outcome of a certain political election. And now we are saying it's unwise to try to do it based on economic forecasts. That is why we don't spend time trying to predict what the stock market is going to do over the next 3 or 6 or 12 months. Doing so causes investors to jump in and out of the market far more often, racking up costly trading commissions and capital gains taxes, and possibly missing out on some great returns even in times of poor

economic growth. As the great John Kenneth Galbraith once said, "The only function of economic forecasting is to make astrology look respectable."

The true path to investment success comes from the study of each potential investment on its own merits—company by company, stock by stock. That's what we try to do each and every day at Inkwell Capital.



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