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February 2024 Crescent Commentary

A Postcard from Japan

Last month, the Japanese stock market reached a new all-time high level. It may surprise you to hear that it took the Japanese stock market 34 years to do this. The Japanese stock market reached an all-time high level in December 1989, then fell 60%, and did not fully recover until February 2024. During the 1980s, an enormous asset bubble developed in Japan. The bubble extended well beyond the stock market to include real estate and private investments. In fact, the bubble is typically called “the Japanese asset price bubble” because it pervaded all major financial asset classes. For example, residential real estate values fell 64% in Japan’s major cities in the aftermath of the bubble.[1][2]

It’s interesting to note that the full recovery of Japan’s stock market comes at a time of exuberance for certain financial assets in the United States. For example, it’s virtually impossible to read the business news without seeing a reference to AI, or artificial intelligence. While AI will no doubt have an impact on business productivity and efficiency, the profit dynamics of companies involved in providing AI services are far from sorted out. Hype and hope for AI profits have pushed stock prices sky high for some assets. If the future doesn’t develop as hoped, investors in these assets will face disappointment.

Another narrative that has driven a return of investor exuberance in the U.S. goes something like this: inflation will continue to fall to the Federal Reserve’s 2% target, the Fed will thus be able to begin significant interest rate cuts, and the higher interest rates we’ve experienced will not lead to a recession. That narrative could prove true. But it’s only one of an almost unlimited number of paths our economy can take from here. And looking to the past, we know that the future typically doesn’t unfold the way investors thought it would. Just the past four years show this. For example, at the end of 2019, the economy was strong and investors generally expected a strong 2020. Instead, covid hit and the market crashed. Then after a strong 2021 with exuberance similar to today, investors expected a strong 2022. But instead the market crashed. After the market crashed in 2022, investors braced for a bad 2023, but instead the market spent 2023 recovering from the 2022 crash. And now that the market has recovered, investors once again feel exuberant and generally expect good things. Yet the past four years show that with investing, we often experience the unexpected.[3]

The reason for pointing out the experience of Japan and the current exuberance in the U.S. is not to say our economy is in a massive bubble. For one thing, many neglected and unexciting segments of financial markets remain cheap right now. For example, dividend paying stocks fell last year, and the bond market has fallen nearly 20% from its all-time high set in 2020. So there is not a pervasive, all-encompassing psyche of euphoria as there was in Japan. Another difference is that the Japanese central bank was slow to raise interest rates to stop the bubble from inflating, and this caused the bubble to spiral out of control. In the U.S., the Federal Reserve quickly raised interest rates to fight inflation, and this caused a pause in the price appreciation of U.S. financial assets.[2]

Although the U.S. has never experienced a bubble on the scale of the Japanese bubble, we have had our own share of "lost decades", or periods where financial assets do nothing for a decade or longer. Over the past 100 years, we've had three of them: the Great Depression, when stocks took 25 years to recover to their previous high set in 1929. 1964 to 1981, when the Dow Jones index was flat for 17 years following the Nifty Fifty stock craze of the 1960s. And 1999 to 2013, when the U.S. stock market was flat for 13 years as a result of a technology stock bubble followed by collapse of a home price bubble.(1)(4)(5)

One thing we always want to do is learn from others' investment mistakes, rather than making mistakes on our own. It's a lot less expensive and painful that way. So, what lessons can we learn from past lost decades in Japan and the U.S.?

The first is to diversify beyond what the investing public is most excited about. There's an interesting story by Bernard Baruch, one of the most successful investors active in the 1920s. He described how everyday people were excited about stocks in the 1920s: "Taxi drivers told you what to buy. The shoeshine boy could give you a summary of the day's financial news as he worked with rag and polish. An old beggar who regularly patrolled the street in front of my office now gave me tips …My cook had a brokerage account and followed the ticker closely." In today's stock market, there are certain stocks and industries that generate a similar level of excitement. While it's fine to own some of those assets to take advantage of potential growth opportunities, it's important to diversify so that if something bad happens, you don't get hurt. One mistake we currently see investors making is they're getting caught up in the excitement about specific companies or industries and not adequately diversifying. This will hurt them when the tide inevitably turns.(6)

Another important lesson is to diversify beyond any single market or index. One fact of bubbles is that they become the largest component of any stock market they're a part of. This is a big part of the cause of lost decades. Because the bubble becomes such a large part of a stock market, that market can be flat for a decade or longer when the bubble bursts. At the Crescent Group, we focus on owning stable assets with a demonstrated track record of strong cash flows over decades and centuries. We do own selected assets viewed as "growth assets", but we own them in diversified amounts so that if something bad happens, it limits the impact to your accounts. We also employ what we call a "barbell" asset allocation, where growth assets are balanced by protective assets, similar to how a barbell is balanced by weights on either side. Because of this, our asset allocations are diversified well beyond a single market or index.

Finally, you want to make sure you're not simply mimicking what everyone else does with investing. Part of the reason bubbles develop is herd mentality. Everyone keeps buying the same thing because it's gone up, which pushes prices higher, which makes investors think it can only go up. At some point something changes, and there's often a stampede to the exits. By diversifying beyond what everyone else owns, an investor can help protect themselves from such a stampede when it happens. This is something that we at the Crescent Group experienced with our client allocations during the treacherous markets of 2020 and 2022, when our allocations demonstrated resilience and protective qualities.

What's great about these lessons learned is that experience shows that investors who followed these lessons in the past did fine during lost decades. For example, during the ten years the Dow index was flat from 1972 to 1982, investors who reinvested dividends earned a 5.4% annual return for the decade rather than the 0% return of the index. How about the 1999 to 2013 lost decade? Investors in a balanced allocation of 60% stocks and 40% bonds who invested their entire life savings near the peak of the bubble in 1998 earned a 6.8% annual return over the next 20 years, despite the fact that the U.S. experienced two of the worst financial crashes in history in 2001 and 2008. We will continue to apply the lessons from the past to help you succeed with your financial plan.(7)(8)

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Forbes Best-In-State Wealth Management Team 2024

Sources:
(1) Fortune. (2) New York Times. (3) CNBC. (4) Wikipedia. (5) FactSet. (6) CNN. (7) Roger Thomas. (8) RBC.