Broadleaf Partners, LLC

Flying High

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The media has made a spectacle out of the Dow Jones Industrial Average reaching new all-time highs. Once again, what may prove newsworthy is not only misleading but also, quite frankly, false.

Allow us to explain.

The Dow Jones Industrial Average and the S&P 500 indices do not include the compounding effect of dividends paid by member companies. Any retiree will tell you that dividends represent a return of capital and useful income in the real economy. If you had reinvested those dividends back in the index as they were paid, the old time highs reached in October of 2007 likely would have been passed some time ago.

According to my calculations, the Broadleaf Growth Equity Portfolio (BGEP), which generates only a small amount of dividend income, exceeded its all-time high last July. On a similar measure, while the S&P 500 index remains four percent below its all-time highs, the total return index which includes dividends, likely exceeded those highs last August.

Why does this even matter? For two reasons.

One, the claim that the stock market has hit all-time highs is needlessly scary to a whole lot of people. If the common indices – including dividends – hit new highs as much as a year ago, then not only are reports of all-time highs old news, but the reality might even serve as an encouragement rather than a deterrent to new investors. By my math, after hitting new highs nine months ago, *the stock market has made further gains*, to the tune of an additional ten to fifteen percent!

Two, dividends do matter, but even more so today. Because of the Fed's zero interest rate policy, dividend increases have been on the rise as a means of attracting yield hungry investors to common stocks. According to Francois Trahan, Chief Investment Strategist at Wolfe Trahan, 80% of stocks now pay a dividend and over 50% of the S&P 500 pays a dividend yield higher than the 10 year treasury, which is currently in the 2% range. A generation ago, the composition of interest and dividends to personal income was likely an 85/15% split, but because of the Fed's zero interest rate policy large corporate cash hoards, and a retiring baby boom generation, that ratio may be closer to 50/50 today.

Regardless of when we hit new all-time highs, some cynics still insist that the stock market's gains are pure fantasy, created solely by the Fed's loose money policies. To be sure, interest rate policy does influence the stock market, but so do corporate earnings. If the recent new highs in the stock market were solely a function of Fed manipulation, we wouldn't expect corporate earnings to be hitting all-time highs. But that, in fact, is what they have done.

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Where are stock prices largely not at new all-time highs? Partly in those sectors which were responsible for the last earnings bubble, namely the homebuilders and the banks. Not too coincidentally, earnings for both of these industries remain well below their peak levels, which also suggest that earnings do still matter and that the current highs in the stock market as a whole aren't solely a function of the Fed's easy money policies.

Our view of 2013 remains the same. The economy is finally in expansion mode - a slow one to be sure - but an expanding one nonetheless. This implies that corporate earnings and the stock market are close to or have already reached their prior highs and are now "expanding" into new uncharted territory. Historically speaking, it is true that economic contractions and recessions typically follow periods of economic expansion, but it is equally true that investors are notoriously poor at timing such shifts.

Our gut tells us that the current expansion might last longer than most expect, simply because it is also a slower expansion than we're typically used to. Economic slack still seems prevalent in the overall environment and the Fed's easy money policies very much intact. Until the Fed believes it has successfully landed on the dual mandate runway of full employment and price stability, low rates will likely remain as they are. Higher interest rates, either due to a shift in Fed policy or natural market forces, might be the first signal that an economic contraction might be just around the corner.

For now though, we still see higher highs.

Kindest Regards,

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