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2016 is in the books – and what a year it was! Few would have predicted that Great Britain would vote to leave the Euro, Donald Trump would become the 45th President of the United States and the stock market would be up double-digits. As John Kenneth Galbraith once said, "There are two kinds of forecasters: those who don't know, and those who don't know they don't know."

U.S. stocks finished up 11.9%.[1] Foreign developed stock markets were up 1.6%, and emerging market stocks 11.2% (the strong U.S. dollar continues to be a headwind for foreign stocks).[2] Bonds eked out a 1.1% gain despite interest rates finally reversing course (more on this later).[3]

Of course the natural question is: What does 2017 have in store? Will stock markets be up or down? Perhaps more interestingly, what will happen to interest rates and the U.S. dollar? Any potential guesses – offered by us or anyone else – are nothing more than that…guesses.

Let's Talk About Stock Prices

The past month, the Dow Jones Industrial Average – a popular measure of stock prices, composed of 30 well-known U.S. companies – flirted with the 20,000 mark. When it finally passes that milestone, the media will make a big deal out of it. Is 20,000 too high? Too low? Just right?

Remember this: stock prices, by themselves, don't really tell us much. It's like saying a car gets thirty miles. *Thirty miles compared to what?* Now if you say thirty miles *to the gallon*, well, now we know something. Likewise, a stock price by itself conveys little information.

Say stock XYZ is at $100 per share. *Well, $100 compared to what?* What we want to know is *how much stock XYZ can earn going forward relative to that price*. If XYZ can earn $10 per share, then we are paying $10 for every $1 of earnings – that appears attractive. But if XYZ can earn just $0.50 per share, then we are paying $200 for every $0.50 of earning – an exorbitant number! Context matters. (These metrics are referred to as price-to-earnings ratios, or P/E ratios.)

Analysts currently forecast that the companies that comprise the Dow Jones will earn around $1,200 in aggregate in 2017.[4] So if the Dow hits 20,000, it will be trading between 16x and 17x its earnings power.

Okay, so is that good or bad? Let's take another analogy – blood pressure. When the doctor or nurse takes our blood pressure, we usually get the "all clear" sign, even though we all might have different readings. But what the doctor or nurse is looking at is whether our blood pressure is *either too low or too high*. If the blood pressure reading is in some "safe zone" in the middle, then no worries. Yet the doctor or nurse doesn't stop there – they also examine our blood pressure in the context of other potential symptoms. Are we light-headed or dizzy? Does our chest hurt? Are we having trouble breathing?

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[1] As measured by the S&P 500 index.
[2] As measured by the relevant MSCI international indices.
[3] As measured by the Citigroup 1-10 Year Government Bond index.
[4] *Barron's* 1-2-17, "Consensus Operating Earnings Estimates for Dow Industrials."

We do the same for stock prices (although in this case "low" would be a good thing – we like to buy stocks when valuations are cheap). Currently stocks are trading around 16-17x earnings. Is this too high or too low, given current circumstances? Current circumstances would include whether we think current earnings estimates are fair or inflated by buoyant economic conditions, and more importantly how the P/E ratio on stocks compares with the valuations of other investment alternatives, primarily bonds.

Compared to historical levels, 16-17x doesn't seem too high. It's not low, but it doesn't seem excessive. Now it could be the case that earnings are overstated, but we wouldn't think dramatically so.[5] Further, despite a recent rise, interest rates are still very low.

At year-end, the 10-year U.S. Treasury offered a yield of approximately 2.5%. This means that if you bought a freshly minted 10-year U.S. Treasury bond to start 2017, you would expect a return over the next decade of around 2.5%.[6] This is still pretty low. And in that context, the current level of stock prices, which is maybe a bit on the high side, doesn't seem *too high.* It would be like the doctor saying your blood pressure is a bit elevated, but there are no other symptoms that signal major risks.

Now this *DOES NOT* mean stock prices can't fall, just like a normal blood pressure reading does not guarantee that you won't have any near-term health issues. All it means is that stock prices don't seem to be at a level that requires any drastic action. That's the best we can say.

How could this change? Well, stock prices could continue rising to a much higher level, or interest rates could go way up and stock prices could stay the same.

So Let's Talk About Interest Rates

If we woke up tomorrow, and instead of getting 2.5% on a 10-year U.S. Treasury, we could get 10%, we would sell our stocks and buy U.S. Treasury bonds. We'd be ecstatic to get a safe 10% rate of return (assuming inflation hadn't gone way up, because what really matters are returns *after* inflation, or the *real rate of return*). Of course other investors would react the same way, and if more investors want to sell than want to buy, stock prices would fall.

But in the past few months interest rates have gone up and stock prices *have risen, not fallen*. What gives? Well, it would probably take a *much bigger move* in interest rates before investors started switching from stocks to bonds. For instance, we might need rates on the 10-year above 4-5% before investors really started to look hard at the comparison between stocks and bonds. So there isn't a direct one-to-one correlation between interest rates and stock prices, but much higher interest rates would no doubt have an adverse impact on stocks. As Warren Buffett pointed out, "interest rates act on asset values like gravity acts on physical matter."[7]

Changes in interest rates *do have* a direct, one-to-one correlation with changes in bond prices, and it's a negative one – if interest rates go up, bond prices fall. We laid this out in a white paper available on our website titled "There is No Such Thing as a Risk-Free Bond." So some readers may ask, if interest rates are rising, should we sell our bonds?

No, not necessarily. Pretty much all of the bonds that we buy are due sometime within the next ten years. The *duration* of our typical bond portfolio – a measure of the portfolio's sensitivity to interest rates – is around four years. This roughly means that if interest rates increased 1% across the board, the value of our bond portfolios would fall around 4%. But in the meantime, we'd also be collecting interest on the bond portfolio of perhaps 2-3% per year. So if this occurred over twelve months, we might lose 1-2% (of course interest rates could go up more). In addition, we own various bonds, with some coming due next year, the year after, the year after that, etc. When near-term bonds come due, we can put them to work at higher interest rates.

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[5] One concern would be if profit margins return to historical levels. Current levels of profit margins are elevated relative to the historical average, but there has been a long-term upward trend and we think there are some reasonable arguments for why margins can remain strong.

[6] The actual return could be less or more, but should be in the ballpark of 2.5%. U.S. Treasury.

[7] Interview with CNBC, April 29, 2016.

If you own a twenty or thirty-year bond, the prospect of increasing interest rates is a scary one. A 1% rise in interest rates would cause the price of a 30-year U.S. Treasury bond to fall by nearly 20%.[8] That would be fine if a 30-year bond was paying you 10-15% per year, but it's not, it's paying you just above 3%.[9] But for bonds that are coming due in a few years, a rise in interest rates isn't catastrophic. Indeed, it would be *welcome*. We'd be more than happy to trade some short-term pain for higher interest rates going forward. And again, you aren't really *losing money*. If you buy a bond due in five years with a yield of 3%, and interest rates immediately rise, the price of the bond will fall. But if you hold that bond until it matures, you will still get a rate of return around 3%.[10] The only difference is that instead of having a steady return of 3% over five years, you will have a negative return in the first month followed by higher returns the next 4+ years, and still average out to 3% over the entire timeframe.

And one more point – while it finally looks like interest rates may start to rise, there is still a reasonable prospect that rates stay relatively low for an extended period of time. It's happened before (just look at Japan since 1990 or the U.S. from 1890 through 1960) and can certainly happen again. So we wouldn't necessarily bet that rates will go straight up from here.

We wish you a very happy New Year. As always, we thank you for your continued confidence.

Sincerely,

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[8] JPMorgan 4Q16 Guide to the Markets, September 30, 2016.
[9] U.S. Treasury.
[10] Indeed, you will actually end up with a *higher* rate of return over the holding period, as you can put any interest received on the bon to work at higher interest rates.