Dow 26,000: Can it happen?

Pundits…are they really?

A lot of market pundits have predicted outrageous levels as targets for the Dow Industrial Average. As a matter of fact following are some predictions that if not stun you, will definitely surprise you:

"Kevin A. Hassett and co-author James K. Glassman startled the financial world with their 1999 book, ***Dow 36,000***…" , Sep 1999

"A Pundit's Bold Prediction--Again Über-bull Harry Dent says the baby boomers' last gasp of spending will lead to ***Dow 40,000***" September 2004

Having gone through one of the biggest bull and bear markets of the century, the mid 1990s bull run and 2000-2002 dot.com bust, I have become a cynical investor and usually ignore such exaggerated statements as mentioned above regarding market predictions.

Having said that, I undertook a simple analysis of the Dow Industrial Average (Index) in an attempt to infer the future movement of the index. Table 1 below represents the movement and the returns of the Dow Industrial Average in correlation to the US gross Domestic Product (GDP) since 1955. The endeavor is to observe the return and the movement of this Index for each decade and use this empirical date to put light on its future movement.

Table 1[1]

Date	Dow Jones Industrial Average	Gain/Loss (%)	GDP Growth (%)
2/1/2007	12,654.85	84.00%	3.04%
2/3/1997	6,877.74	209.25%	3.15%
2/2/1987	2,223.99	137.50%	3.31%
2/1/1977	936.42	11.56%	3.11%
2/1/1967	839.37	103.79%	4.06%
2/1/1955	411.87		
Average		**109.22%**	**3.34%**

Observations

It can be clearly observed that the Index has returned an average of over 100%+ per decade. The most important aspect in considering returns for various time horizons is to recognize how smooth or consistent the returns are. In other words, the volatility or returns around the mean. With an exception of the period between 1967 and 1977, all other periods under consideration have returned close to or higher than 100%.

It can also be observed that the US GDP has been growing at an average rate of 3%+ since 1955. In addition, inflation for the last 10 years has been contained at an average of 2.55%[2].

[1] Source: CGAM, LLC & http://finance.yahoo.com/

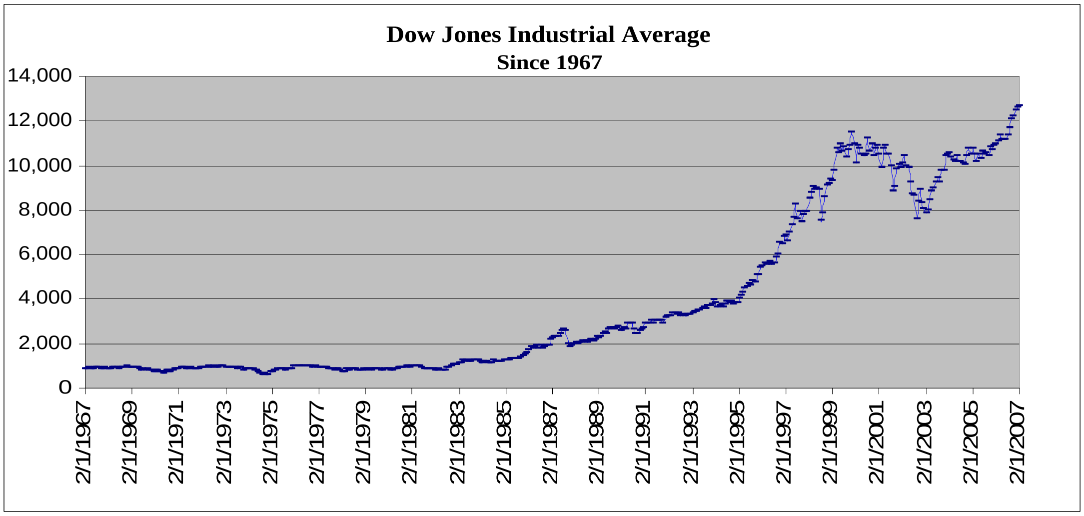
[2] Source: www.inflationdata.com

17991 Lost Canyon Rd., Suite 138
Canyon Country, CA 91387
Office: 661-299-1920
Mobile: 661-312-2070
Email:manuwalia@cgamadvisor.com
www.cgamadvisor.com

Table 2[3]

Index	1975	2005	Gain / Loss (%)
Dow Jones Industrial Ave.	**619**	**10,726**	**1632.79%**

Figure 1



Volatility in the market return

Table 2 above illustrates that an investment in the Dow Industrial since 1975, would have gained over 1600%. On the same token we can not ignore the volatility in the market during the same period. Illustrated visually in Figure 1 and statistically in Table 3 below, we are reminded of the realities of investing in the stock market.

Table 3

Year	Date	Dow Industrial Average (Index)	Loss
1929	Oct-1929	400	
	Nov-1929	145	**-63.75%**
1969	1965	1,000	
	1969	765	**-23.50%**
1972	Dec-1972	1,020	
	Sep-1974	607	**-40.49%**
1987	Aug-1987	2,746	
	Oct-1987	1,616	**-41.15%**
2000	Jan-2000	11,908	
	Oct-2002	7,181	**-39.70%**

[3] Source: CGAM, LLC

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While the market provided handsome returns for the last thirty to forty years, we can clearly observe that the market lost more than 20% (a measure of a major correction) at least once every decade. Pretty scary!!!

Growth in the Market…

Despite the realities of market meltdowns illustrated above, the fact is that an important element to bolster this growth, the Gross Domestic Product (GDP) has been consistently growing at an average of 3%+ each decade. Currently, even if the US maintains a GDP growth of approximately 2.5-3%, it will grow its GDP more in absolute terms than any other country in the world.

If we believe that the markets will not be impacted by some exogenous unsystematic factors; a natural calamity or an unfortunate event like 9/11, the index should double by 2017 based on the empirical historic returns. This translates to the Index gaining almost 13,500 points over the next 10 years or approximately 115 points each month on an average for the next 120 months.

…shall bring a higher volatility

If one believes that this trend is sustainable it should be noted that the volatility in the market in absolute terms will also increase significantly. A 100-200 point positive move in the Index is very palatable for investors, but a negative experience of the same magnitude compels us to believe that we may be headed towards disaster or a completely new paradigm of investing which has risks not faced by investors in the past.

The emphasize here is the emergence of perceived volatility in the market as we move into another decade of growth that will hopefully be fueled by global trade on the main street translating into economically fruitful results on Wall Street.

While we read and digest this outlandish view and prediction, we should remember "Those who have knowledge don't predict. Those who predict, don't have knowledge.
—Lao Tzu, sixth-century B.C. Chinese poet

Prepared By: Manu Walia

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