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THE BEAR WENT OVER THE MOUNTAIN

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Conquering the fourteener

It has been a long time coming. In March, the S&P 500 Stock Index revisited its 2007 peak levels, finally recovering the losses from the Great Financial Meltdown. It has taken almost 5½ years. The Dow Jones Industrial Average also reached new highs. Never mind "Dow 36,000," it is a relief that the measure moved back above 14,000.

Stock returns have been robust in the New Year, producing an entire "average" year's worth of gains just in the first three months. There are now signs that some absent investors have begun to reallocate their money into stocks. This may well be from a fear of being left behind. But it may also reflect the lack of many other attractive investment opportunities. Meanwhile, breathless CNBC hosts are hailing the return of the bull (market, that is).

The long and short of it

Perhaps, but we think it is still a bit premature to declare the "all clear." Let's take a longer view back in time. It is critical to distinguish between a mere cyclical recovery and the emergence of a new upward trend.

For context, it helps to look at the historical record. Like some other forces on Mother Earth, the stock market tends to move in long phases. These prolonged, or *secular*, trends typically span multiple business cycles. They may be characterized by generally rising stock prices (secular bull) or by falling or sideways movement (secular bear). Note, however, that in the midst of these powerful trends, markets will still be subject to sizable short-term (cyclical) swings.

20th Century Bull (and Bear)

The 20th Century was characterized by three great bull markets. During the Roaring Twenties, 1921-29, the Dow rose from 60 to 380 (+500%). Next, from 1942 to 1966, reflecting the post-World War II boom, the Dow surged from 90 to about 1,000 (+1,000%). Lastly, from 1982 to early 2000, with the rise of globalization and the Internet-enabled PC, the Dow exploded from 800 to 11,700 (+1,400%).

In the intervening periods, stocks tended to struggle. It is commonly accepted today — with hindsight — that the market has been in a secular bear's grip since the bursting of the tech bubble and stock market peak in early 2000. The current great bear represents the fourth since 1900. Secular bears usually begin after a long-term market peak and a crash. They tend to have sharp rallies and selloffs but within a broad trading range. So a decade or so into one, it is not uncommon to look back and see little net change in stock prices, despite the large rallies. This is certainly the case now, thirteen years in.

During these grinding periods, price-earnings multiples contract because investors become less willing to pay up for a given dollar of earnings. And often, a general malaise infects society, due perhaps to war or a loss of faith in our political institutions. Main Street loses interest in stocks and focuses on other investments like bonds or real estate; ratings fall for financial TV networks. Sounds familiar.

Fidelity released a study recently (using the S&P 500 as the market proxy) concluding that the average secular <u>bull</u> market has lasted 21 years. It has produced an *annualized* total return of 17%. And the market P/E doubled from 10 to 21. In contrast, the average secular <u>bear</u>, including the current one, has lasted 14½ years, has produced annualized returns of about 1%, and has witnessed P/E's dropping from 21 to 11.

Hibernation in sight?

So here we are, entering the fourteenth year of a trend of languishing stock prices. Over this entire period, the S&P 500 has returned just 1.5% per year on average. The market P/E contracted from 28.6 to 9.6 (March 2009) and is now back to 16.5. No doubt, stocks have been in a *cyclical* bull market since the 2009 lows. Indeed, stock prices are up 125% from those dark days. But this performance did not occur in a vacuum; it followed a 55% swoon over the preceding 17 months. And it is an unfortunate law of arithmetic that a 50% loss requires a 100% rebound for one to be made whole.

Have we reached the end of this vexing period of subpar returns? Many pundits have confidently weighed in, yea or nay — they are frequently wrong but never in doubt. Unfortunately, that question really cannot be answered until well after the fact. And the Federal Reserve's unprecedented monetary easing has muddied the waters. Critically, it has helped prop up a fragile economy, but the policies may have also prevented markets from fully capitulating. Normally, even deeper angst and lower valuations would coincide with the resurgence of a new, long-term market cycle. Fed actions may have mitigated, or possibly just delayed, a final washout.

We would argue, nevertheless, that the secular bear market is much closer to its end than its beginning. A stock market attaining higher highs and higher lows, with rising P/E multiples, and a break in the cloud of pessimism would ultimately be signals of the approach of the long-term bear's hibernation. Stay tuned.

Short-term limits

Meanwhile, on a short-term basis, stocks do appear a bit frothy. In each of the previous three years, we have watched the same movie: Stocks rally early in the year, only to sell off during the spring and early summer. And for largely the same handful of reasons: namely, concerns about U.S. jobs, gridlock in Washington, the European debt crisis, and the trajectory of China's growth. Some or all of those issues will likely flare up again this year. With the recent surge by stocks, it would not take much of a catalyst to temporarily reverse some of the gains. But that would be normal.

We *are* still concerned about the uneven economic recovery in the U.S. And Europe, of course, represents another story altogether. First-quarter GDP growth will likely be decent at around 3%, but that partially reflects one-time factors such as inventory restocking and the Hurricane Sandy impact. The next few quarters will bear the brunt of the fiscal tightening — the spending cuts from the sequestration as well as higher payroll and income taxes. This backdrop lends support to the notion that stocks may come under some pressure as the year progresses.

Yet while the next few quarters of economic growth may be erratic, the medium-term outlook appears favorable. Major sectors such as housing and autos are in the early stages of a cyclical recovery. BCA Research points out that the country's capital stock has barely grown in real terms over the last five years, an unprecedented event in the post-WWII era. The inference is that there should be significant pent-up demand for business equipment, industrial and commercial space, and durable goods as we look out over the next few years.

Lack of interest

The real wildcard for businesses, consumers, and investors may well be the future path of interest rates. These also move in long phases. And we have benefited from a 32-year cycle of generally falling Treasury yields. At current low levels, rates are sending the unwelcome signal that the global economy still has substantial unused capacity; too much slack. The Federal Reserve has explicitly stated that monetary policy will remain very loose until this slack — as indicated by the unemployment rate — dissipates.

Extremely low interest rates have obviously aided new borrowers and those with variable-rate loans. But the law of unintended consequences has also kicked in. Savers and, specifically, those relying on interest income to support retirement have been hammered. Before the recession, a million-dollar portfolio of 2-year Treasuries produced $50,000 of annual income. Today, that same portfolio dribbles out $2,500 annually. As a result, many fixed-income investors have had to reach for yield, putting their capital at more risk.

So interest rates need to move up — and they will move up. The question for stock and bond investors is how quickly they reset and to what degree. Clearly, rates can increase somewhat without retarding economic growth; indeed, that would be a sign that growth itself is set to improve. And historically, there has been a positive relationship between P/E ratios and 10-year Treasury yields up to the 4% threshold. Put another way, multiples have tended to expand until that point. The 10-year now stands at 1.8%.

Pin the tailwind on the bear

Interest rates could be impacted by other cross currents besides the growth outlook. We have gone through a generation-long period of declining rates thanks to diminished inflation expectations. A hat tip to Paul Volcker and his colleagues in the early 1980s who broke the back of inflation. Bernanke and his crew have been battling the opposite but equally evil foe, *deflation*. At $3 trillion, the Fed's balance sheet has become massive, as bonds are purchased to expand the money supply. The Federal Reserve will have to carefully extricate itself from this posture and at the appropriate time. Otherwise, policymakers risk unleashing inflation fears again.

At the moment, interest rates show no indication of moving up sharply anytime soon. And that benign view may also partially explain the resurgence of stocks. It is certainly a tailwind. The Dow and S&P 500 continued to hit new all-time highs in April. The glass-half-full crowd crows that the market is breaking out, upward and onward. They are ignoring signs that hurdles still remain. The half-empty crowd warns that prices must drop since they are so "high." True, they may be at record levels, but they have still gone nowhere in a decade. As usual, the truth is likely somewhere in the middle. We will endeavor to stay out of the crowd(s).

— Christopher J. Singleton, CFA, Managing Director
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