MDP ASSOCIATES LLC
INTERIM NEWSLETTER #8
August 30, 2010

Secular Bull and Bear Markets in Terms of P/E Ratios

As you most likely have read too often, I have been writing that we are in a secular bear market that began in 2000. The so-called secular periods usually last 15-20 years. The last complete secular bear in terms of year-to-year dates was 1966-81, and it was followed by the incredible secular bull market of 1982-1999. Normally we think of these periods in terms of the movement of stock prices. These bull markets see steady strong rises punctuated by sometimes scary drops (such as in 1987) that are recovered in a few years or less. In contrast, the bear periods see stocks moving sideways in nominal terms and much lower in inflation adjusted ones with drops of over 50% or more that can take many years to recover.

Another way to view what happens is in terms of stock valuations. At the beginning of a secular bull market they are historically low or "cheap." During the secular bull market they rise to very high or "expensive" levels. The following secular bear market reverses the course. The most popular measure of valuation is the price-to-earnings ratio, which is often expressed as the P/E. For the broad stock market, looking at the P/E of the S&P 500 index serves as a general indicator of how expensive or cheap stocks are at points in time.

Today's *Wall Street Journal* has an article titled "The Decline of the P/E Ratio" discussing its current trend down and saying it "is in danger of losing some of its prominence as a market gauge" due to "less reliable" "profit and economic forecasts" resulting in a focus on other factors. This may be true when looking at shorter term market movements, but I think relative P/E levels are a good indicator of the progress of secular bull and bear markets.

The article included a chart, which is reproduced below courtesy of that newspaper, that dramatically illustrates the behavior of the ratio during the secular periods and indicates that the current secular bear is far from over.

While the chart illustrates four periods, all during secular bear markets, when the P/E ratio has fallen by a large amount in a relatively short period, I don't think that is the big story here. Note the low values at the beginnings of the secular bull markets in the late 1940s and early 1980s. They were well under 10. The current ratio is close to the long-term average shown on the chart of 15. Some pundits have claimed that shows stocks are currently "fairly valued." Whether or not that is so, if this secular bear market is going to be like the previous ones, it won't end until the P/E drops to somewhere near half of its current value.

It is important to point out such a decline does not mean the S&P will fall by 50% from where it is now although some hyper-bears are predicting that and even worse. There are two ways the P/E ratio can move lower. The P can fall and/or the E can increase. I suspect we will see a combination of both. The most worrisome scenario is if earnings fall over a period of years, which quite likely would result in prices falling sharply to bring the P/E level down close to the historical lows. That case will make the purveyors of doom look prescient.

The above does not mean that I think owning a broad market index such as the S&P through a traditional mutual fund or an exchange traded fund should be a no-no until stocks get cheap as evidenced by a substantially lower P/E. I expect that it will take another 7-10 years before the start of the next secular bull market. However, during that time there almost certainly will be so-called cyclical bull markets that last for a few months or even a few years. We have already seen a couple in the past ten years, which are essentially indicated by the

spikes in the right section of the chart. I will continue to rely on models that identify the major trends of the broad stock market in general and the S&P 500 in particular. Those models, like all other trading methods, are far from infallible. In particular, they are subject to whipsaws—false breakouts—that result in poor short-lived trades like the one we had earlier this month. That is the price paid for being on the right side of the major trends. The design and historical performance of the models indicates they will continue to fulfill that function quite well.

Mark Pankin
703-524-0937
mdp2@pankin.com