Stock Market Perspective: Bulls, Bears, Cicadas

Have I found a new "natural" market indicator? No, I am just borrowing a fun way from one of mutual fund manager John Hussman's fine weekly commentaries (www.hussman.net) to get into another discussion of secular market trends. Those typically last 15-20 years, or about 17 years as an average. And 17 years is the time interval between cicada visits in the mid-Atlantic region. About a month ago, those bugs were out in full force, but the next generation has now gone underground until 2021. Note how the cicada years—2004, 1987, 1970, 1953, 1936, and so forth—alternate between the first parts of the last few secular bear and secular bull markets.

The fact that 17 is a prime number is part of the cicada survival "strategy." No predator with a shorter re-emergence period would regularly find them available for food. There are also 13 year ones. Why other primes, such as 11 or 19, are not the length of a cicada cycle is a question for entomologists to answer. The other part of their survival strategy is the huge numbers that emerge, up to 1.5 million per acre. Although they are tasty (according to some experts in that type of cuisine) and defenseless, there are far too many for the birds, squirrels and other critters to devour, so lots are left to reproduce.

A secular bear market can do a lot more damage than cicadas. There is a good way to prevent it and still make money in stocks.

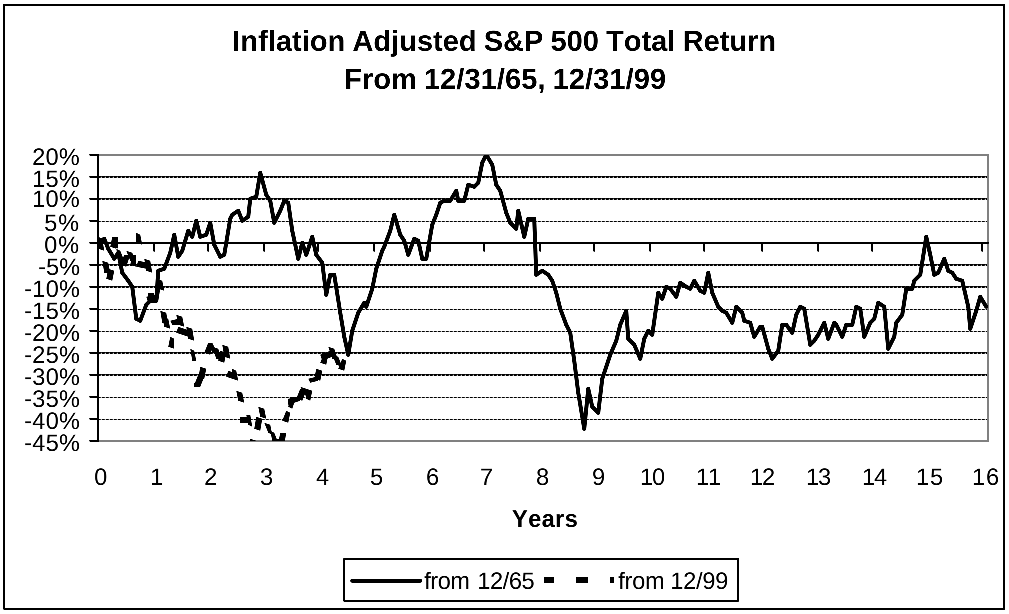
That leads to the question, and one point of this perspective, of why do secular bull and bear markets last so long. Since it appears a secular bear market began in 2000, I will focus on those. By many measures stocks were "overvalued" then,[1] and by the time the long-term bear market ends, most of those indicators will show undervaluation. That has been the historical pattern although the precise course between the two extremes shows considerable, and hence unpredictable, variation. Why will it take so many years to get from one extreme to the other?

The answer most likely is that there will be enough "cyclical" (shorter-term) bull markets along the way to stir up enough hope, which is often expressed as "this time is different because …" and move stock prices higher for awhile. This is quite natural since lower prices eventually attract some buyers to "correct" the "oversold" condition. Depending on how one views it, that type of cyclical bull market began in October 2002 or March 2003. It looks as if it may have spent itself out, but since the last half of a presidential election year tends to be a good time for stocks, another surge in stock prices would not be a real surprise.

To get an idea of how this works from the point of view of stock prices, let's look at the last full secular bear market. Rather than worry about determining the precise start and end dates, I will use full years, so it was during 1966-81. Because we invest to preserve and grow purchasing power, I will show the inflation adjusted S&P 500 total return. That takes into account the dividends received, which are assumed to be reinvested, and then reduces the return by the effects of inflation as measured by the Consumer Price Index (CPI). During the prior secular bear market, dividend yields were much higher than they are now, but inflation was generally more than it is now, particularly in the late 1970s. The graph on the next page shows how the inflation adjusted S&P 500 total return performed relative to the end of 1965. For comparison it is also shown relative to the end of 1999 so we can see how the current secular bear market is going.

[1] It is worth noting that many of those measures first indicated overvaluation two or three years earlier. By themselves, they are not timely indicators of market extremes.

The graph shows data as of the end of each month. The initial drop through September 1966 was about 17.5%. It was recovered fairly quickly and the market had gained ground by early 1988 when another sharper drop started. However, by early 1973, the market was about 20% above its level seven years earlier. On an annualized basis, that is a far from impressive 2.6% rate of return. It shows that even in a secular bear market stocks can produce positive "real" returns for some periods, but at a poor rate compared to historical performance.



The next two years show how vicious a secular bear can be. By the end of September 1974 the index was 42% below its level almost 9 years earlier, and had lost over half of its value from the earlier peak, a good portion of which was due to rapidly increasing inflation. Stocks gained ground for a couple years after that low, a good cyclical bull market during the long-term bear market. After retreating and moving sideways the next cyclical bull period brought the buying power of stocks back to where they had been almost 15 years earlier. Buy and hold investors over that period were probably happy to have recovered their losses, but that ignores the opportunity cost of not investing in better places. Stocks fell again, and it was not until 1983 that they moved and stayed ahead of the level at the start of that secular bear market.

The current secular bear has started out quite differently than the prior one. A large decline similar to that of 1973-74 but not as bad when inflation is taken into account happened right at the beginning. It is interesting to note that at the end of May (the June CPI is not out yet), the drop below the end of 1999 is almost the same as the earlier one after 4.5 years. That does not bode well for the next 12 plus years. However, by the time the cicadas come back again, we likely will be in the midst of a secular bull market.

The graph shows damage that a secular bear market can do, especially for those who are nearing or in retirement, can be quite severe. A good way to protect one's investments during such times is by using risk reduction models to get out of stocks when the risks of owning them are high. That is exactly what my tactical asset allocation program seeks to do. I have discussed it at length in prior editions. Please get in touch with me if you have questions, would like more information, or want to receive a copy of the relevant issues. Also, I have added a section to my web site that provides more data and has examples of how the models work: "www.pankin.com/retire/".