Stock Market Perspective: Is the Secular Bear Losing Its Claws?

Conventional "wisdom" defines a bear market as a 20% drop from a previous high, and also uses a gain of that size to establish a bull market.[1] The size of the gains since early March has generated a lot of talk and writing about whether the March lows will be the ultimate lows of the secular bear market that began in 2000. If so, we may now be in a secular bull market.

> *The secular bear market is now over nine years old. Have we seen the low point as we did by one measure in the last one?*

My guess is that the secular bear is still on the prowl, so the current rise is a cyclical bull market rather than the start of a very long period of rising markets. I say that because secular bear markets in the past have not been over until valuations are beaten down to historically low levels. For example, in late 1974, the price-to-earnings ratio for the S&P 500 fell to about 8, and in late 1979 and early 1980 is was around 7. Currently, its P/E based on *estimated* earnings for the next 12 months is in the 15-17 range. Bullish pundits say that is a "fair value" because it is close to some historical average or another depending on the period of the average.

There are a couple of problems with that reasoning. Since current earnings are depressed, the current P/E based on *trailing* earnings is quite high, over 70 according to *The Wall Street Journal.* Since earnings are almost certain to improve, it makes sense to use estimates, but earnings estimates are notoriously inaccurate. Even if a P/E around 15 is some sort of "fair" value for stocks, markets typically overshoot "correct" valuations in both directions. If prior secular bear markets are any guide, we are going to see a P/E based on real, not estimated, earnings much lower than 15.

In order to get some idea of how the current secular bear may play out, I will compare what we have seen so far with the last full one in the 1966-82 period. That will at best provide a rough idea. One prior comparison has no statistical significance. Moreover, the end of the period was more than a quarter century ago and its beginning was more than four decades in the past when LBJ was the President and Obama was starting elementary school.

The approach is looking at the changes in percentage terms of the S&P 500 from the high points in 1966 and 2000. I use close of the week data to keep the graphs from becoming too messy. In 1966 the weekly high of 93.81 was made on February 11. In 2009 dollars, using the Consumer Price Index (CPI) to make the adjustment, that value is 626.93. That is less than ten percent lower than the low the S&P made this past March, 43 years later, which shows how secular bear markets can be devastating to longer term investment returns. The highest weekly close in 2000 was on March 24. The index was at 1527.46, or 1908.04 in constant 2009 dollars.

The on the next page is based on the inflation adjusted weekly index values. The longer solid line tracks the index in the 1966-82 secular bear market. The chart goes through the end of 1982 even though the market bottomed out in August. The shorter dashed line shows the index changes since March 24, 2000, the start of the current secular bear market, which is now more than nine years old.

There are some striking similarities and differences. The actual S&P made new highs in the 1969 and again in early 1973. Adjusting for

[1] Since it takes a 25% gain to recover a 20% loss, the definition of a bull market should require that much of a gain. Wisdom is in quotes due to "thinking" that a fixed percentage can define a change in the animalistic nature of the stock market.

inflation, the movement was essentially sideways, which is not unusual in a secular bear market. In contrast, the index lost about half of its "real" value in the first three years after 2000. About seven years into the periods, the index topped out and fell sharply. In the older one, it almost reached the 1966 high. However, when it made new nominal highs in 2007, the S&P was still almost 20% lower in constant dollars than it was at the start of the secular bear market. After those peaks, the sell offs in the next year to two years were quite severe leading to drawdowns of around 60% in inflation adjusted terms.

The cyclical bull market that began in late 1974 had its peak about 15 months later about 43% above the low in constant dollars. That rise is not as great as in the current cyclical bull market and it took quite a bit longer. After that, the overall trend down resumed for nearly another six years.

The graph on the previous page suggests that we are about half way through the current secular bear market. Such is consistent with bear periods historical length of 15-20 years.

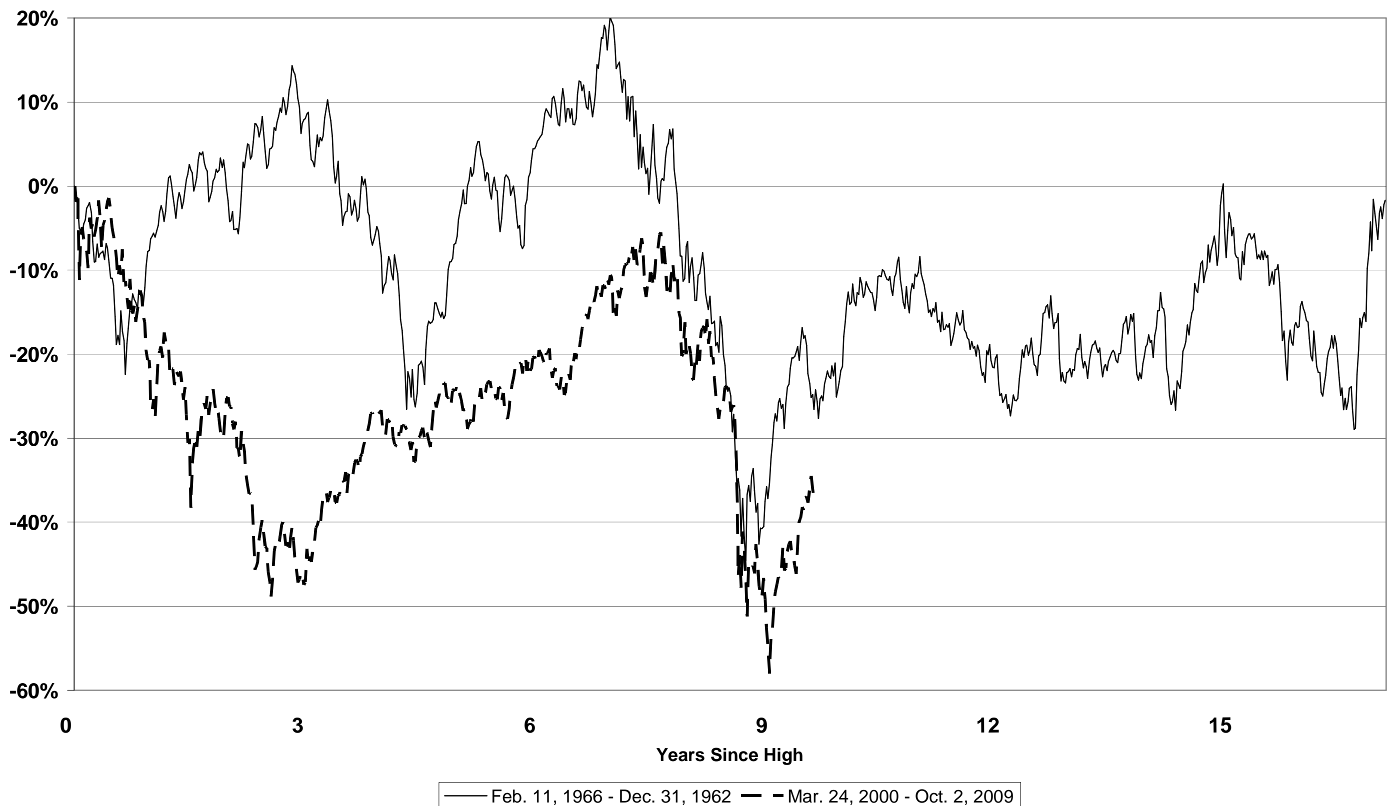
One significant difference between the current one and the last half of the prior one is the rate of inflation. After pushing above 5% for a few months in the summer of 2008, the year-over-year change in the CPI is now negative and figures to remain quite low for at least another year. The greater concern now is avoiding a prolonged and deep deflation that could lead to a very severe recession or a full depression. The annual change in the CPI climbed steadily in the early 1970s and peaked over 12% in late 1974[2] when the drop in stocks from the early 1973 peak bottomed out. Inflation dropped briefly under 5% in 1976 before soaring to about 14% in 1980. Those high values pull down the inflation adjusted S&P shown in the chart.

Another major difference between the current environment and the 1966-82 period is the

[2] You may remember President Ford wearing a WIN button standing for whip inflation now.

dividend yield on the S&P. Back then the yield level rarely got much below 3%, which was sometimes considered an indication that stocks were overvalued. By late 1974, the yield was over 5%. It fell to under 4% later in that decade before rising to a peak of 6.4%[3] in June 1982, a couple of months before the low at the end of the secular bear market. In contrast, the S&P's yield in 2000 at the end of the long secular bull market fell to just a bit over one percent, and is still below 2.5%.

Dividend policies of most corporations have changed considerably, so it is unlikely that the higher level of yields will be seen any time in the foreseeable future. One factor in the 1970s was that the high inflation often enabled companies to raise their prices, which resulted in increased nominal earnings and the capability to pay higher dividends. To improve the comparison between the two periods' market movements, the graph below shows the total return of the S&P 500 adjusted for inflation. The total return lines assume reinvestment of the dividends, which is normally what happens with an index tracking mutual fund. There were no index funds in 1966; Vanguard started the first one in 1976. A very low expense ratio fund such as that one, ones offered by some other fund companies, and the exchanged traded "spiders" fund will closely track the total return of the S&P 500.



We can see that when looking at the total return, the drop in late 1974 was reduced quite a bit, from almost 60% below the start of the secular bear to a little over 40%. The drop since 2000 also is reduced, but not by a whole lot, from somewhat over 60% to a bit under that level.

The high dividend yields resulted in the total return inflation adjusted low point during the prior secular bear being in late 1974. In November 1980, the purchasing power of the

[3] Data downloaded from the web site of the *American Association of Individual Investors (AAII).*

total return index was back to where it was in February 1966 for a couple of weeks. At least the "buy and hope" investor in a hypothetical S&P index fund with a zero expense ratio would briefly have preserved his or her purchasing power over an almost fifteen year period.[4] That assumes the investor could stand seeing the fund lose almost half of its purchasing power and could hold on and not sell the fund.

The chart suggests that the worst of the current bear market may be over. As long as inflation remains very low, even today's meager dividend yields will enhance the inflation adjusted total return of the index. Due to current corporate dividend policies, it is unlikely that the yield on the S&P will rise significantly unless stock prices move sharply lower, which would result in the dashed line falling substantially. Another reason the current market may not keep up with the late 1970s is that inflation may well pick up if the economy starts growing again. There has been a lot of money pumped in by the Fed. Although it claims it will be able to drain liquidity to prevent high inflation when the time comes, that is a daunting task requiring precise timing to avoid severely hurting the economy. Based on the uncertainties and difficulties involved, the past Fed performance suggests that it will not be able to achieve its goals all that well.

Another reason I am not optimistic about the chances of the future course of the dashed line following the solid one is the P/E ratios discussed at the beginning of this section. In other words, despite the two deep drops we have seen since 2000, I don't think the level of fear among the investing public has yet reached the capitulation point where it takes an immense amount of courage to continue owning stocks, much less buy more. That is the sort of pessimism that marks secular bear market lows. Please note that these views do not affect my management of your accounts as well as my personal ones because it is done using thoroughly tested formulas that tell me when I should or should not be in stocks.

[4] The fund would need to have been held in a hypothetical IRA or 401(K) type account, which did not exist in 1966, or there would have been taxes to be paid on the fund's distributions. Even in such an account the taxes due when money was withdrawn would bring the real after-tax returns to less than breakeven.