The BOECKH INVESTMENT LETTER

SPECIAL REPORT

JANUARY 17, 2011

Why the Secular Bears are Wrong

Be Wary of a Consensus

There is a pretty widespread consensus that U.S. stocks are in either a secular bear market or a sideways trading range that will last for years. Such a view is not surprising since a consensus is almost always formed by what has already happened in the recent past, an experience that has not been kind to equity portfolios. In the last 11 years, the U.S. experienced two of the worst bear markets in history and the S&P 500 is still 16% below its all time high in early 2000 in nominal terms. After adjusting for price inflation, it is down about 35%.

Defining secular bear markets in stocks is not straightforward. They are generally thought of as lasting a long time, sometimes ten years or more. However, that is not always the case. The magnitude of decline is also a key factor and a dramatic decline that takes prices to unsustainably low levels can shorten the secular bear market very substantially. Also, looking at total returns changes the picture considerably because dividend yields are high after a steep market decline. Nonetheless, we will focus just on the trend of stock prices which is more conservative, (i.e., shows weaker performance) and provides a sufficiently accurate picture.

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Some think of secular bear markets as lasting until the previous highs have been sustainably exceeded. However, this approach is not very meaningful for those dealing with the future and making asset allocations accordingly. Others would define secular bear markets as those in which valuations (e.g., P/E ratios) continue to fall. That can be interesting information in the sense that falling P/E ratios create a headwind for stock prices; but what ultimately raises investor wealth and improves balance sheets, is rising stock prices. As a result, we consider secular bear markets to be those where prices are trending down or, in the case of bull markets, trending up.

Our particular interest in such trends comes from an increasing concern that the secular bear market consensus now is too widespread. A consensus usually is wrong when it has prevailed for a long time. There is a good chance that this one is also wrong and investors should start taking a fresh look at where the long-term trend of U.S. stock prices may be heading. Clearly, there is no way to "prove" that we might actually be in a secular uptrend. Conditions always look terrible in the early stages. When the prevailing news is fraught with dangerous macro problems after big losses, it's natural to be cautious when there is a lot of gloom and doom around. It is then difficult for investors to overcome groupthink and set aside their biases and emotions.

The essence of the creation of a new base from which to launch a secular bull market is twofold. The first is a market overreaction to all the obvious bad news. The second is a silent, below the surface, adjustment to the well publicised macro problems that is largely obscured by the cacophony of bearish noise. Households and companies, for example, do improve balance sheets and become more competitive after a credit crisis.

It should also be kept in mind that virtually all major secular bear markets occur in either one of two very negative environments. High and accelerating general price inflation is one, and it is always a disaster for equities, as for example in the 1968-82 and 1906-19 bear markets. The other type of negative environment is a credit collapse and debt deflation with widespread expectations of depression and falling price levels. This was what lay behind the bear markets of 1929-32 and 2000-09 in the U.S. and in Japan after 1989. Naturally, all secular bear markets begin with extreme overvaluation.

Stock markets do best when general price inflation is low and fairly stable, the banking system is solid and valuations are reasonable.

Chart 1(next page) shows overlays of four secular bear stock markets: three were in the U.S., from 1929-49, 1968-82 and 2000-09, and one in Japan from 1989 onwards. This is shown in inflation-adjusted terms. Chart 2 shows three of those bear markets in nominal terms. We left out the 1968-82 bear because it was very high price inflation that wiped out most of the market value. Most investors have seen these charts in one form or other.

The unspoken implication of looking at these overlays is that the U.S. broad stock market, as measured by the S&P 500, is only half way through the secular bear market that began in early 2000. This conclusion is readily accepted by an enormous number of pundits, economists, strategists, bloggers and gold advocates and reflects the widespread prevailing consensus. We think the odds are low that the consensus will turn out to be right.

Chart 1

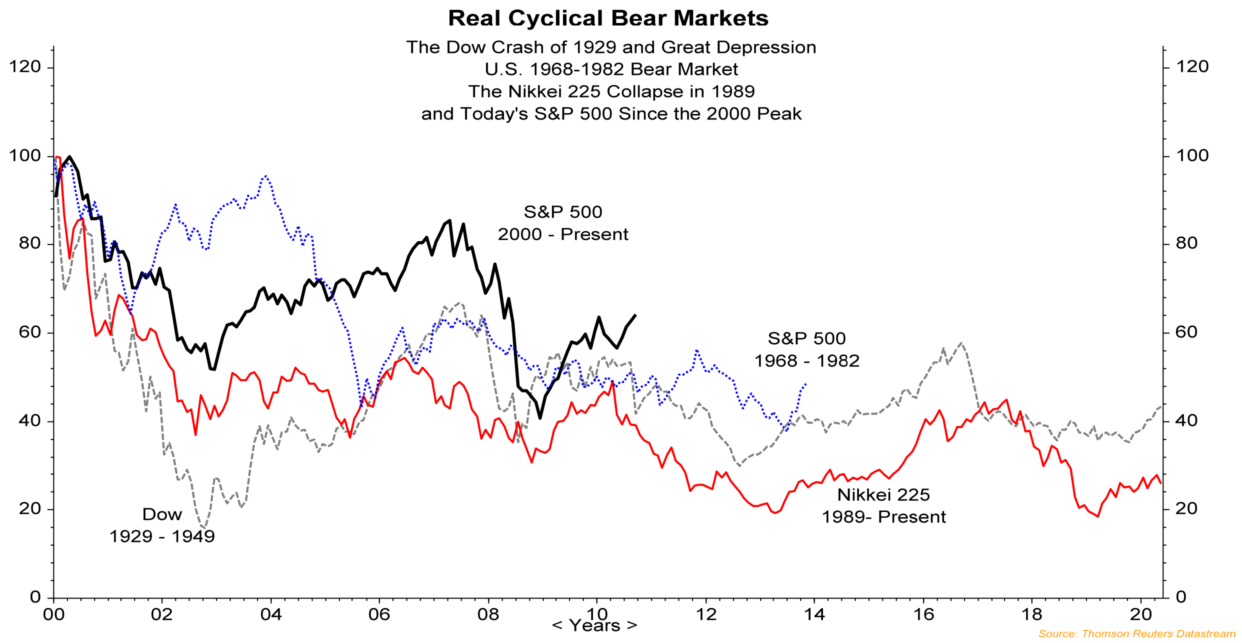
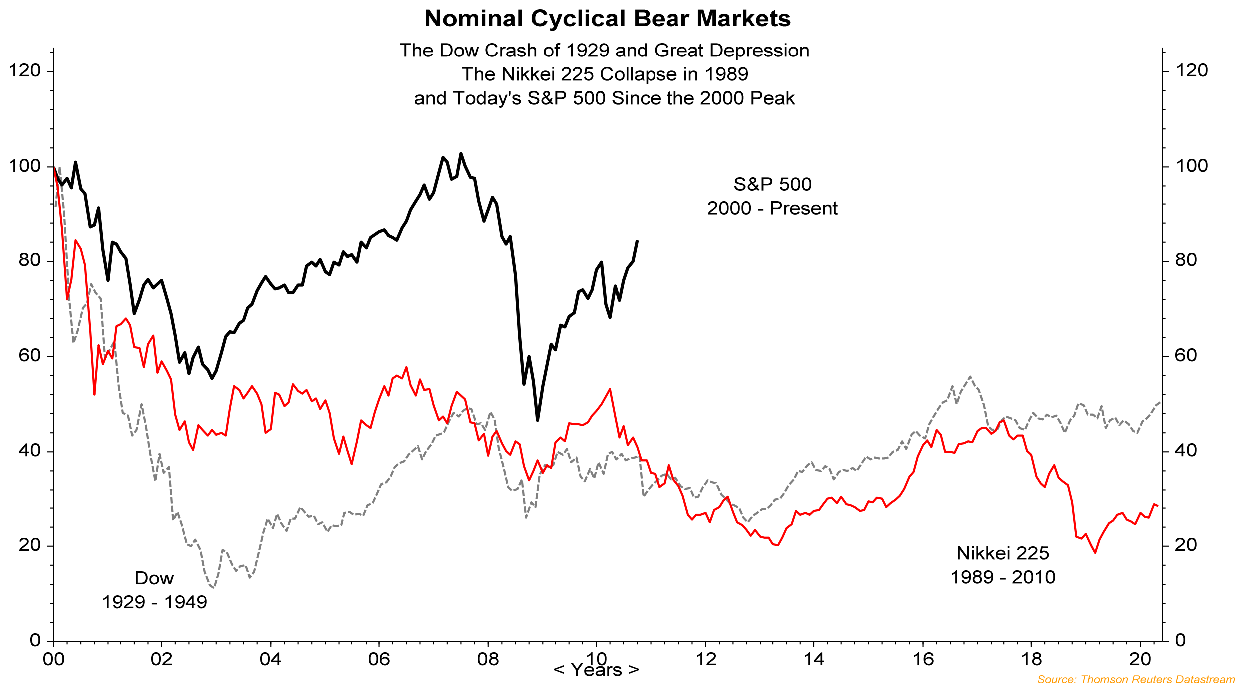


Chart 2



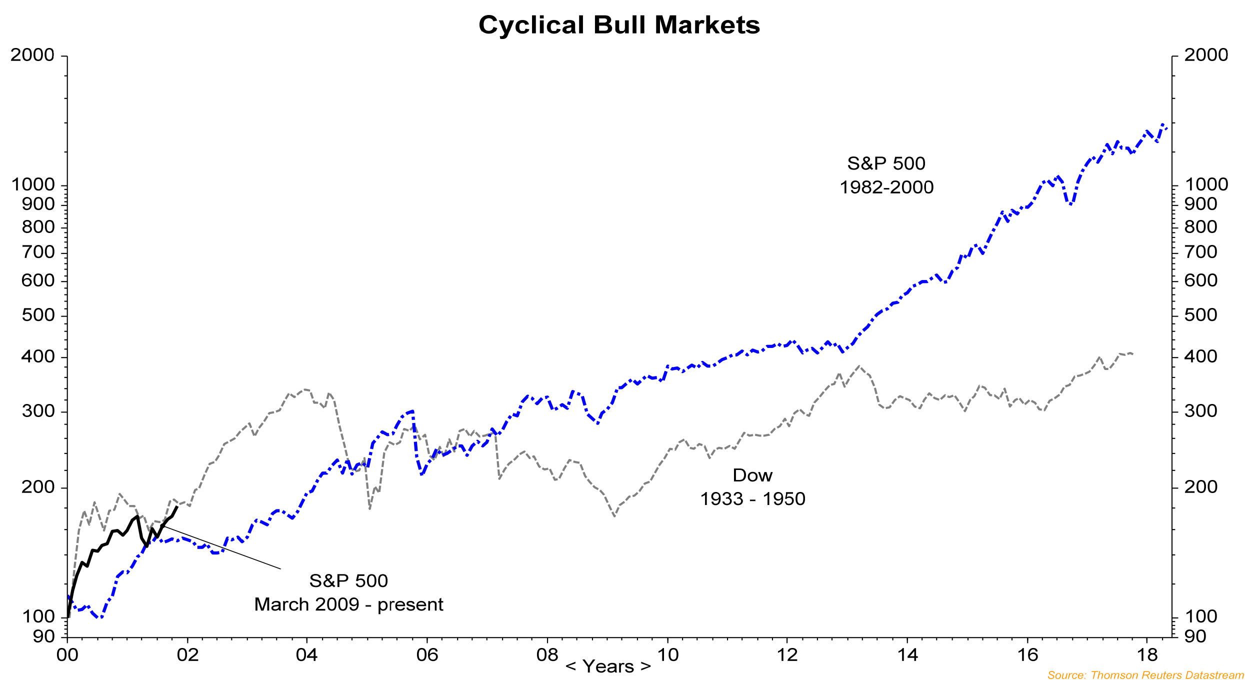
The U.S. Post 1929 Secular Bear

It is generally thought that following the market peak in September 1929, the U.S. stock market remained in a secular bear market until the early 1950s when the previous high was surpassed.

U.S. policy was a series of deflationary disasters after 1929 until President Roosevelt re-valued gold in March 1933. That happened to be very close to the low in the stock market and the end of deflation. Another policy mistake by the Fed in 1936-37 was in tightening too soon out of misplaced fear of inflation, causing a further sharp decline in stocks. However, the bottom then was far above the low in 1932-33. The outbreak of war in 1939 caused another cyclical sell-off until 1942, at which point it was clear the allies would win. The result was a double bottom in nominal terms compared with the 1938 low leaving intact the uptrend from the 1932-33 base.

Chart 3 (next page) shows the bull market from the bottom in 1932-33. It continued until the peak in November 1968 (the chart only goes to 1950). Dating the beginning of the secular bull market in 1932-33 is unconventional. But it was the time to increase allocations to stocks and get over the emotional trauma of the great losses of the previous four years. From the low, stocks had a bull run of 35 years and made fortunes for those who were not hung up on the fear of another stock market collapse.

Chart 3



As is always the case, really strong secular bull markets begin at a time of maximum fear. That fear persisted well into the 1950s. The widespread assumption then was that the world would go back into another depression after the war was over. It wasn't until the late 1950s that investors shook their belief in bonds as the only prudent investment and began to increase their allocation to equities after almost 25 years of rising stock prices. It wasn't until 1956 that dividend yields actually fell below corporate bond yields.

All secular bull markets end with the last holdouts throwing in the towel. The widespread belief towards the end is that it will go on forever. In the 1950s and 60s, the emotion was driven, in good part, by the democratization of capitalism and the stock market. By the late 1960s, several "reputable" financial economists produced attention-getting learned papers making a bulletproof case for a permanent shortage of equities

due to the rise of mutual funds and pension funds as large buyers of stocks. These studies helped to create the hype needed to form the secular top in 1968. A 14 year secular bear market then ensued, taking the S&P down 63% in real terms to the low in 1982. This is discussed below.

A key point to keep in mind is that during the 35-year bull run, almost no one recognized it was a secular bull market until it was almost three-quarters over because of the trauma of the 1929-32 collapse. The real end of the post-1929 bear market came about when policy shifted from deflation to reflation, mistakenly assumed then to mean inflation.

After the U.S. devalued against the then monetary standard of gold, prices started to rise, balance sheets began to repair and companies started making money again. However, deep fear of another collapse remained, a fear that was further fuelled by the recession and bear market of 1937-38, which was triggered by the Federal Reserve's misplaced obsession with inflation and the fiscal authorities' paranoia over deficits.

Reflation after the 1929-32 crash, beginning with the U.K. exit from the gold standard in September 1931, but particularly with the revaluation of gold by the U.S., was viewed darkly as a scary experiment and departure from orthodoxy, much like the widespread concerns over the current reflation experiment and QE2. The deep hostility to the Roosevelt Administration further compounded uncertainty, and created a visceral fear of socialism in the U.S. Simplistic parallels were often drawn then with Weimar Germany in the early 1920s and its hyperinflation.

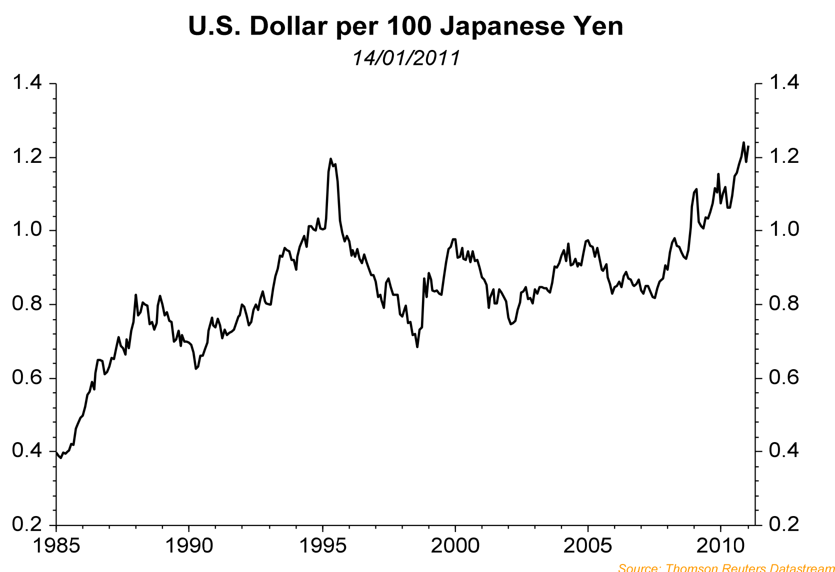
Japan after 1989 Versus the U.S. Now

Japan's secular bear market is also shown on the charts on page 4. Since the peak in 1989, the inflation adjusted Nikkei 225 is down about 76% over the last 21 years. The nominal decline is almost the same [as Japan's price inflation has been negative as much as positive]. Japan clearly has been in a secular bear market over the period since 1989 which is very instructive for investors today. The inflation-adjusted Nikkei made new lows at years 9, 13 and 19 following the peak and the cyclical rises have formed declining tops.

However, it is a big mistake to assume that the U.S. market will follow Japan's pattern in the future. There are several reasons. First, Japan did not devalue against the prevailing monetary standard, which was, and still is, the U.S. dollar. In fact, Japan allowed the yen to rise sharply against the dollar after the crash. Chart 4 (next page) shows the steep rise in the yen against the dollar for the five years before the crash in 1989-90. After a brief correction, it then exploded upwards again until 1996. After a series of corrections since 1996, it started to rise again and, currently is back around its all time high at an overvalued exchange rate.[1]

[1] A lower inflation rate in Japan than the U.S. over the last 20 years has somewhat mitigated the overvaluation indicated by the nominal exchange rate.

Chart 4



Second, Japan did not repair its banking system after 1989 as the U.S. has done since 2009 and did after 1933. Most of the non-bank speculation in Japan prior to the collapse was in Japanese corporations, rather than the household sector as was the case in the U.S. Japanese companies responded, in good part, to the sharp rise in the yen and squeeze on profit margins prior to 1989 by engaging in massive financial and real estate speculation/manipulation. They could borrow very cheaply because of the Bank of Japan's monetary policy designed to counter the effects of the rise in the yen. When the mania ended, collateral values collapsed undermining most of the banking system and corporate sector. The authorities felt it was better to hide the problem than to face it openly. Bad debts were not written off and recapitalization did not take place effectively. The result was 20 years of loan liquidation to repair balance sheets and 20 years of massive budget deficits to protect incomes and employment, leaving the country with a gross debt that is 220% of GDP.

Importantly, the loss in wealth in Japan, as a result of the decline in asset values, was three times the amount of GDP. Japan's published P/E at the peak in 1989 was about 60 but earnings were highly inflated from financial speculation. If the Shiller cyclically-adjusted ten-year average of earnings was used, the P/E would have been close to 100 or three times the cyclically-adjusted P/E in the U.S. in late 1929 and two and a half times the U.S. peak in 2000.

Japanese real estate was just as overvalued as the stock market. The often cited example of the Emperor's gardens being worth the equivalent of all of California is but one example. It is true that Japanese residential real estate prices rose about as much as those of the U.S. for the 15 years before each countries' top and fell about the same 30% or so, for the first few years thereafter. But real estate prices in Japan continued down in the following years. The collapse in Japanese land prices was worse by a whole order of magnitude. From the peak in 1989, they fell about 90% by 2008. U.S. residential real estate has stabilized over the past year but it can't be known yet that it will hold. In the 1929-33 and 2008-09 U.S. asset price collapses, the total loss of wealth was only 1/3 of Japan's or roughly the equivalent of one year's GDP. With the dramatic rise in U.S. stock prices since the March 2009 low, the loss of U.S. wealth has been sharply reduced.

There are also other factors[2] at work that suggest quite strongly that the U.S. will not replay Japan's dismal performance of the last 20 years. One of these is demographics. Japan's population is aging more rapidly than the U.S. and shrinking. The U.S. population is still growing.

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[2] See "Boeckh Investment Letter", Special Report, Brian Reading, December 22, 2010.

U.S. Secular Bear Market 1968-82

This secular bear market, unlike the others discussed above, was driven by high and rising price inflation. Like all others, it started from extreme overvaluation with the 10-year cyclically adjusted P/E ratio at almost 23. At the bottom in July 1982 it was about 6 ½. The S&P price decline, after adjusting for price inflation, was about 63%. Real profits did fall but not that much. The decline in valuation caused most of the damage. A good part of that decline was caused by the upward spiral in nominal interest rates. Late in the cycle, real interest rates also rose sharply, ultimately reaching the 17-20% level as a result of Paul Volcker's anti-inflation policy. The monetary contraction and high interest rates in the early 1980s, contrary to fears at the time, did surprisingly little damage to the economy. Jobs took the brunt of the adjustment and unemployment rose to over 10% for awhile. Real profits did fall a further 12% or so after the stock market low but investors were looking ahead to the positive impact of falling interest rates and disinflation on equities.

Some Lessons for Investors

Paul Volcker's stiff anti-inflation policies of the early 1980's were the equivalent of reimposing a disciplined monetary standard on the U.S. and this created credibility and confidence that inflationary policy was over. This always signals the end of these secular bear markets which are driven by high and rising inflation, such as 1906-19 and 1968-82. Reimposition of a monetary standard doesn't have to mean a return to the gold standard, although sometimes it does. For example, this was the case after the Napoleonic wars and after the U.S. civil war. After WWI, there was the expectation of a return to gold by the U.K., the then reserve currency country of the world. After 1980,

the U.S. did not return to gold but Paul Volcker and the Fed made it clear that U.S. money and credit inflation was over, in good part by targeting non-inflationary monetary growth. The Weimar hyperinflation ended in November 1923 with the replacement of the papiermark by the rentenmark which was based on land and strictly controlled issuance. The inflation ended abruptly and the stock market began a new secular bull market.

Secular bear markets driven by balance sheet recessions, credit crises, and debt deflation end when countries go off the prevailing monetary standard and/or devalue against it. Markets and economies in the 1930s began to recover quickly in each country that went off gold. For the U.S. this occurred in March 1933.

The U.S. dollar is the current international monetary standard so obviously the U.S. can't go off the dollar or devalue against itself. But what the U.S. can, and did do, was make it clear that monetary policy would not be constrained by any concern for the dollar's external value. The Fed, starting in late 2008 early 2009, began the most massive expansion of its balance sheet in peacetime history with the aim of pushing price inflation up to its target level of 2% and restoring balance sheets. The dollar has been relatively stable in part because the outlook for most other major currencies is equally bearish.

The other key to ending secular bear markets in a debt deflation environment is to recapitalize banks and improve balance sheets. The U.S. has done this. Corporate, household and bank balance sheets are vastly improved over the past two years and the loss in wealth relative to GDP has been cut almost in half. It is now about half of

one year's GDP whereas in Japan it was running about six times GDP 12 years after the crash.

Chart 3 on page 6 shows the stock market since the low in March 2009 as an overlay with the secular bull markets of 1982-2000 and the post 1933 bull market plotted up to 1950 (it lasted for another 18 years). As indicated earlier, it is controversial to call 1933 the start of that secular bull market but we think it is defensible. In nominal terms, lows of 1938 and 1942 created a double bottom at about the same level as the recovery high following the first leg up in the market.[3]

Conclusion

Whether March 2009 is the beginning of a new secular bull market will only be known after the passage of time and several significant rallies and pull backs. But investors owe it to themselves to keep an open mind as to this possibility.

Certainly, big problems remain largely unresolved, as we have discussed repeatedly in our letters. These include the eurozone debt crisis, spiralling U.S. government debt, global imbalances based largely on China's undervalued exchange rate, and rapidly rising food and energy prices that could drain household incomes excessively. These problems will, doubtlessly, rear their ugly heads and trigger periodic sharp stock market declines. But it is altogether a different question as to whether prospects for a new secular bull market will get derailed. History shows that all great bull markets climb the so-called wall of worry. There are always problems to obsess

[3] Technically, the 1942 market drop did take prices somewhat below the 1938 low, particularly in real terms. However, that reflected a brief war time sell-off. Prices were spiking up at the same time so real stock prices fell even further, albeit temporarily below the 1938 low. Within 12 months, according to Shiller's data, even real stock prices were above the 1938 low.

about, but it is arguable that action is being taken which could lessen their negative impact, possibly quite significantly.

Investors with a long-term focus and willingness to live with volatility should take a more positive attitude toward equities. If, in fact, we are in a secular bull market, stock prices will be higher in five and 10 years and investors can feel more comfortable riding out the periodic corrections. This is not the case in secular bear markets.

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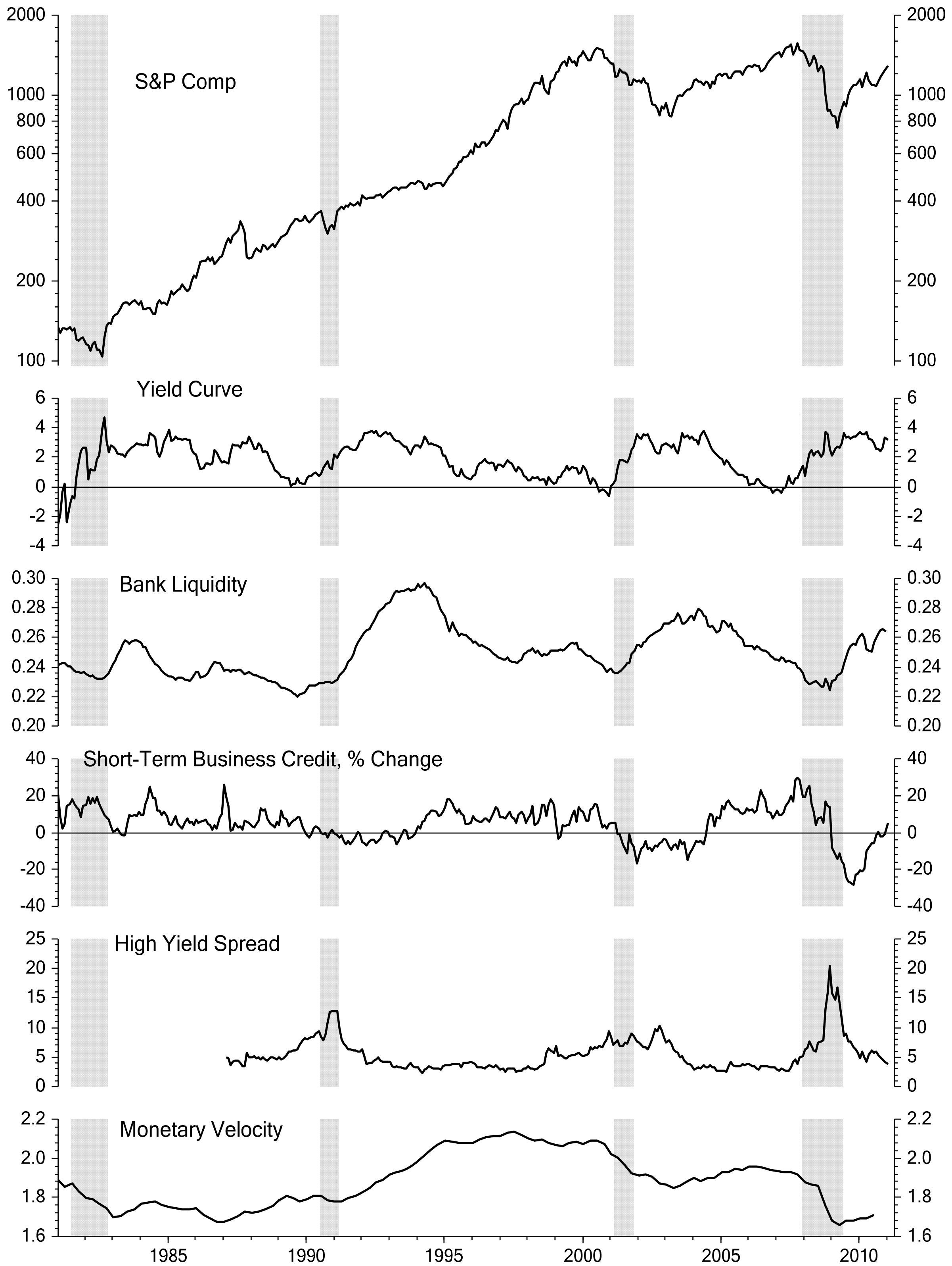
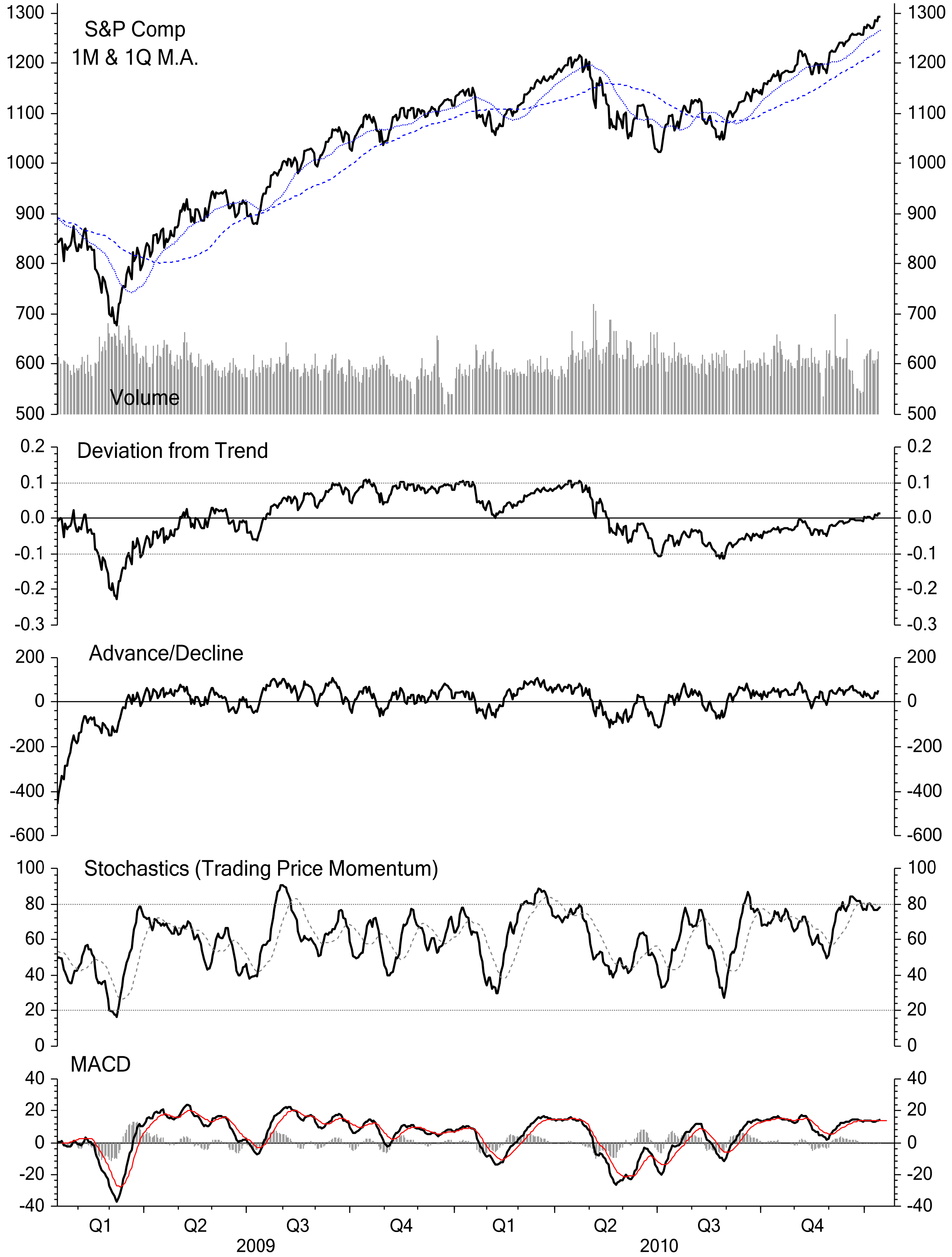

U.S. Key Liquidity Indicators
14/01/2011
S&P Comp
2000
1000
800
600
400
200
100
Yield Curve
6
4
2
0
-2
-4
Bank Liquidity
0.30
0.28
0.26
0.24
0.22
0.20
Short-Term Business Credit, % Change
40
20
0
-20
-40
High Yield Spread
25
20
15
10
5
0
Monetary Velocity
2.2
2.0
1.8
1.6
1985
1990
1995
2000
2005
2010
Source: Thomson Reuters Datastream

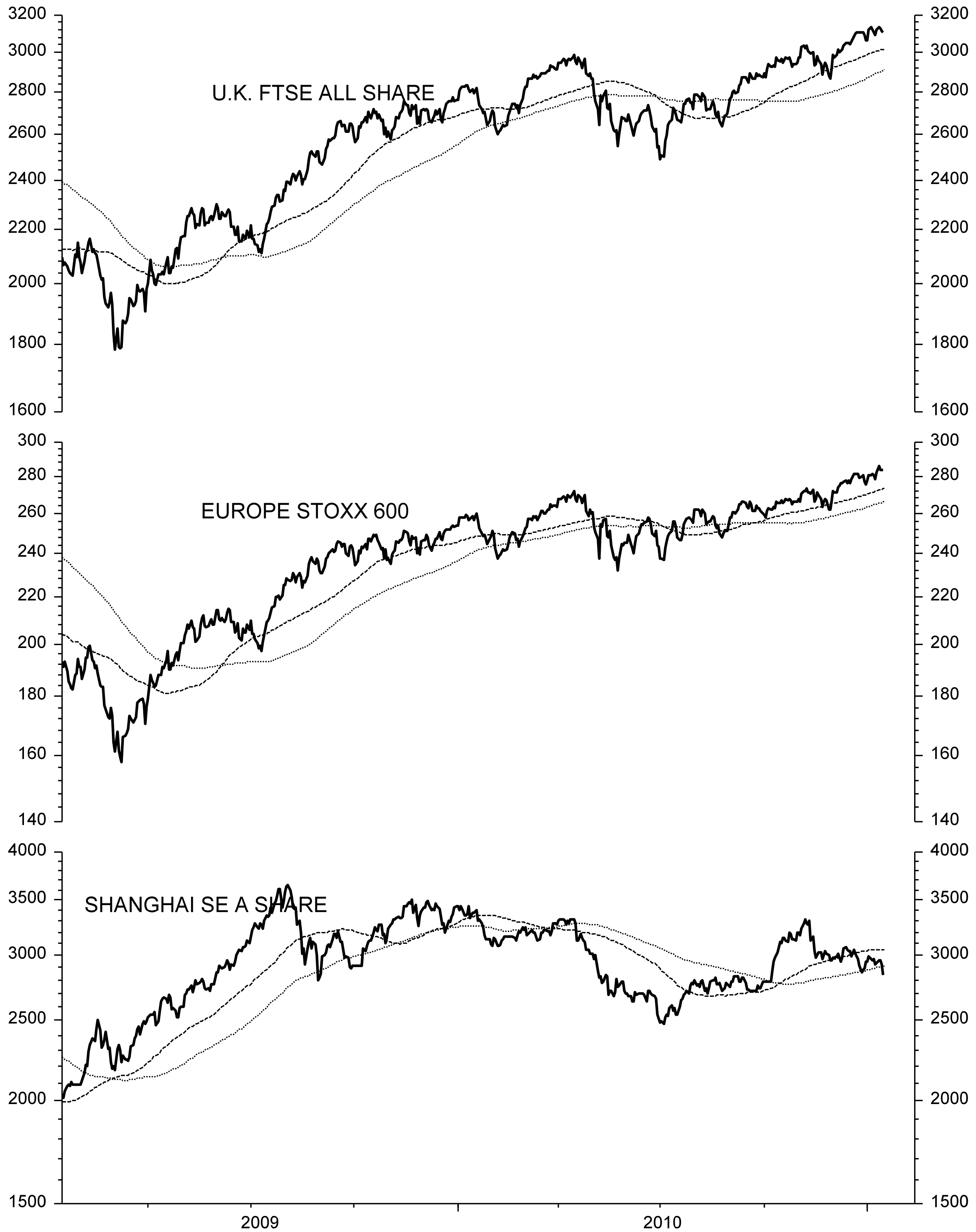
U.S. S&P 500 Technical Indicators

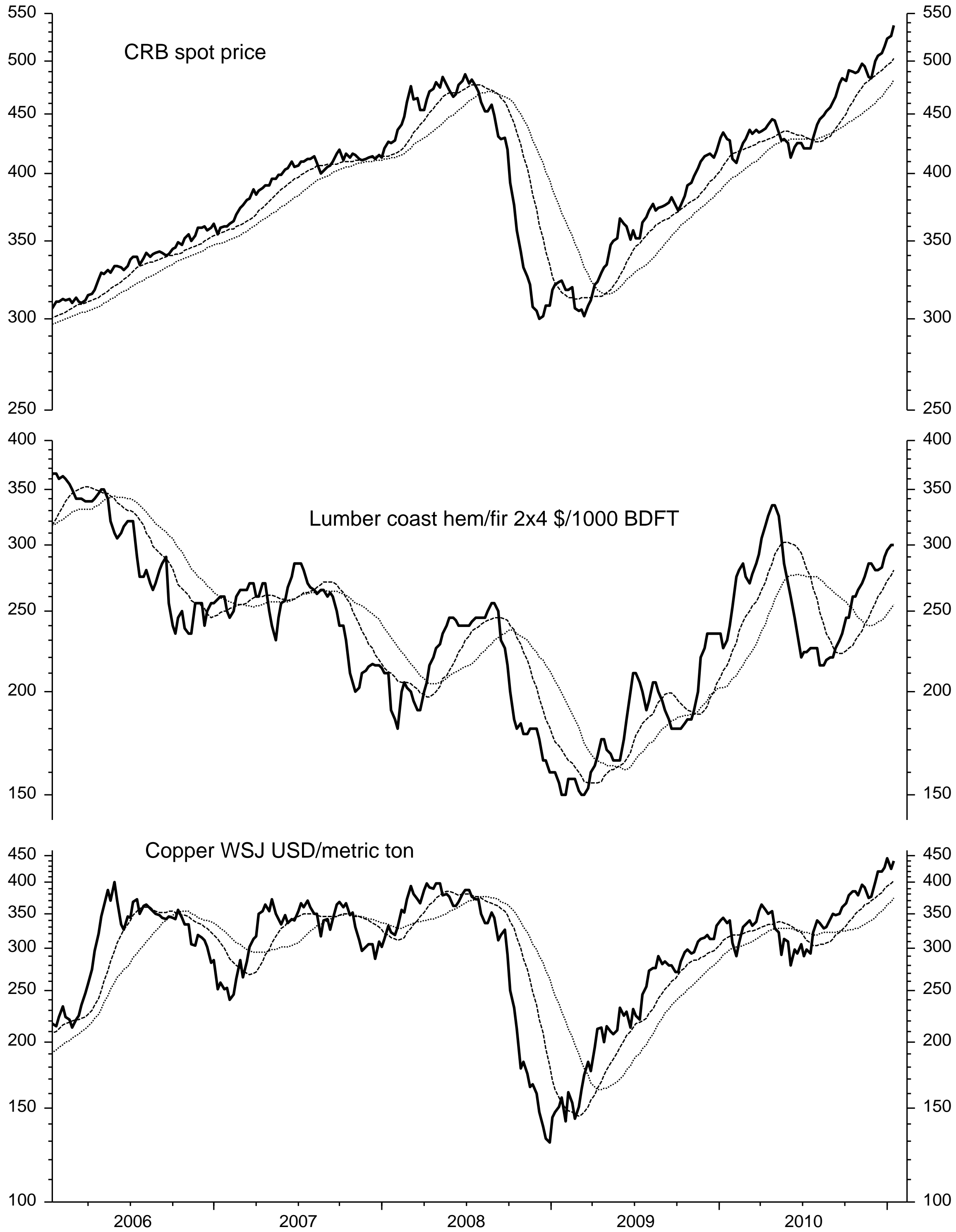
14/01/2011

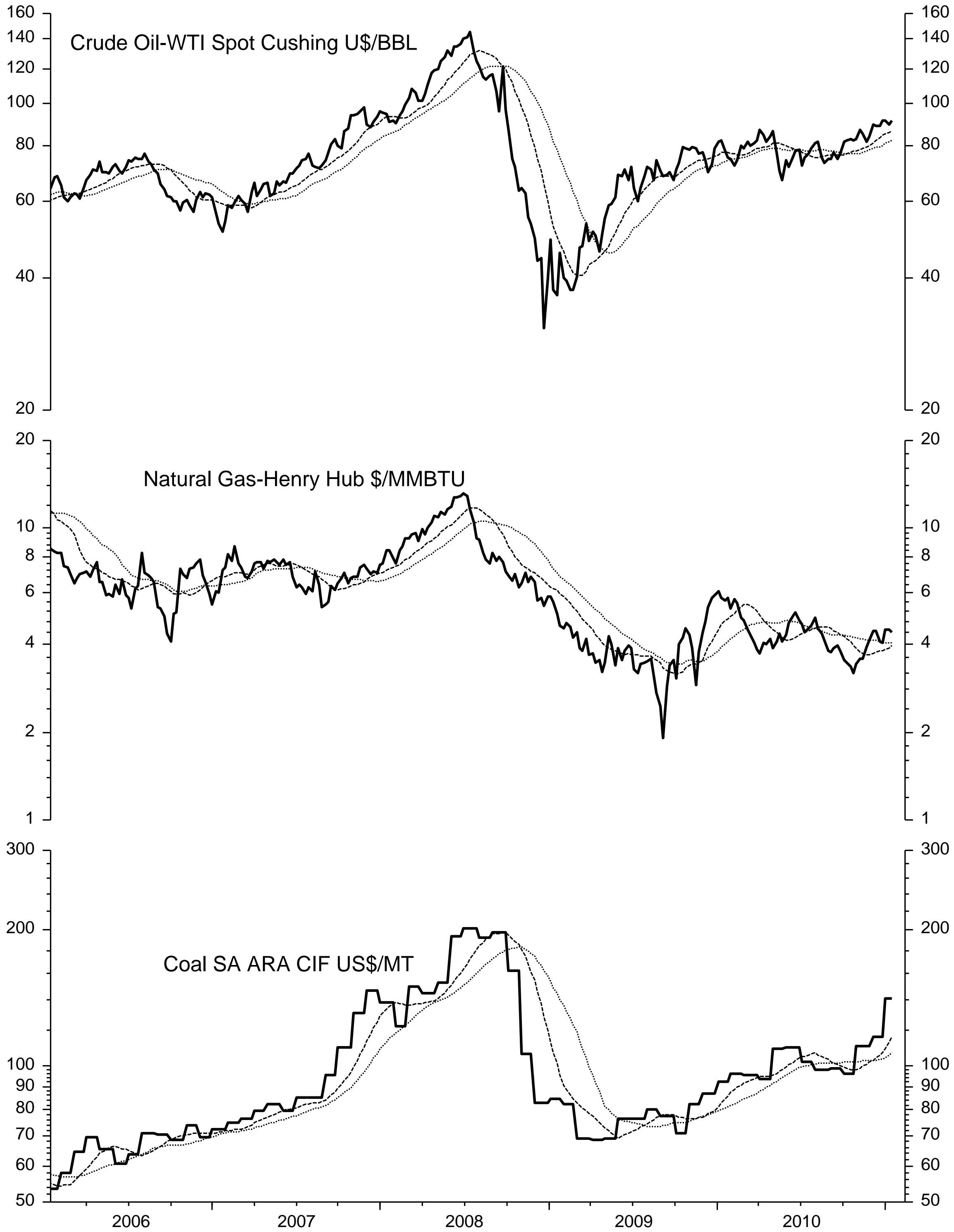


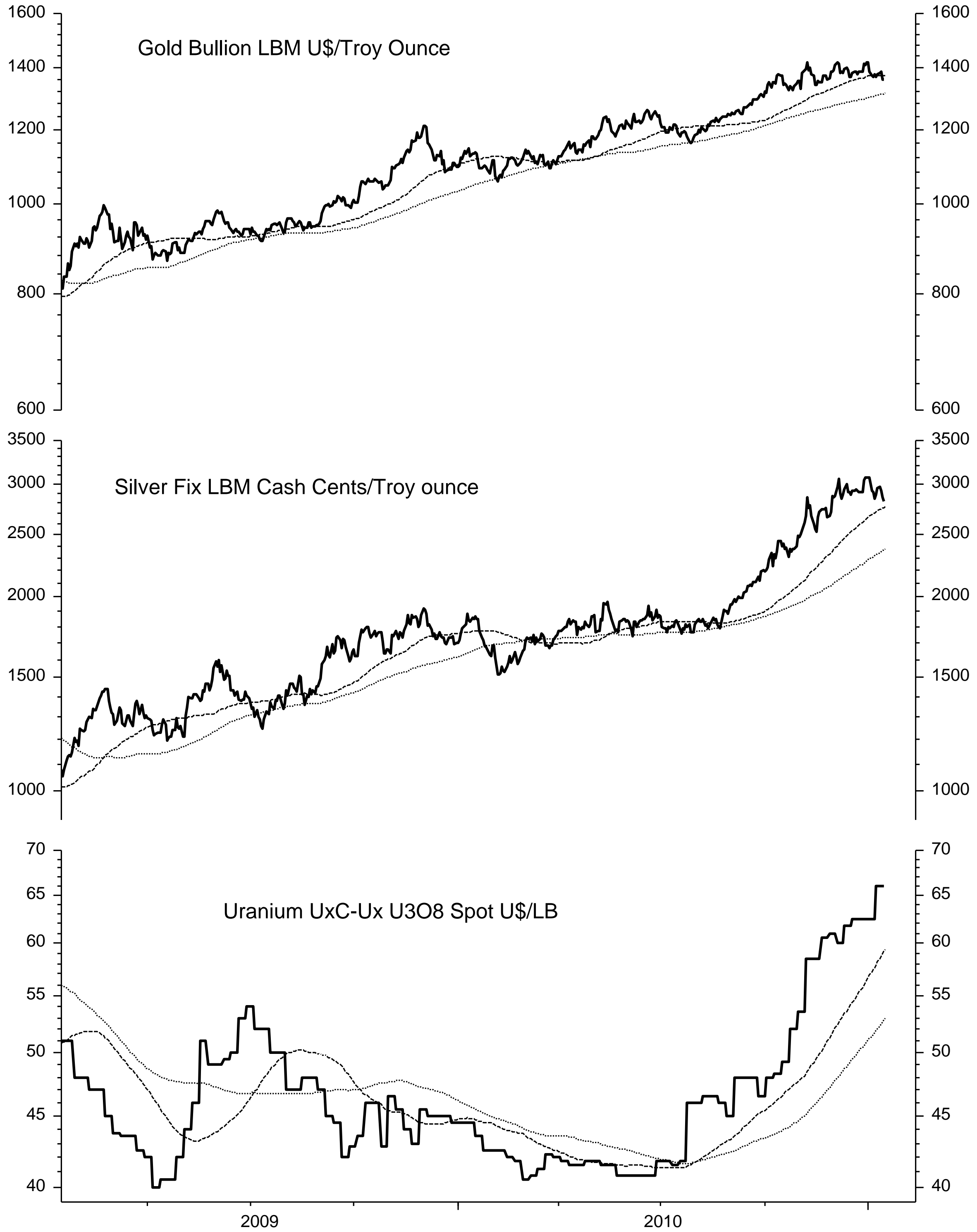
Source: Thomson Reuters Datastream

EQUITIES
Latest: 14/01/2011
1 & 2 Quarter Moving Averages
S&P 500 COMPOSITE
1300
1200
1100
1000
900
800
700
600
NASDAQ 100
2400
2200
2000
1800
1600
1400
1200
1000
x 1,000
CANADA S&P/TSX COMPOSITE INDEX
14
13
12
11
10
9
8
7
2009
2010
Source: Thomson Reuters Datastream


EQUITIES
1 & 2 Quarter Moving Averages
Latest: 14/01/2011
U.K. FTSE ALL SHARE
3200
3000
2800
2600
2400
2200
2000
1800
1600
EUROPE STOXX 600
300
280
260
240
220
200
180
160
140
SHANGHAI SE A SHARE
4000
3500
3000
2500
2000
1500
2009
2010
Source: Thomson Reuters Datastream


COMMODITIES
Latest: 14/01/2011
1 & 2 Quarter Moving Averages
CRB spot price
Lumber coast hem/fir 2x4 $/1000 BDFT
Copper WSJ USD/metric ton
2006
2007
2008
2009
2010
Source: Thomson Reuters Datastream

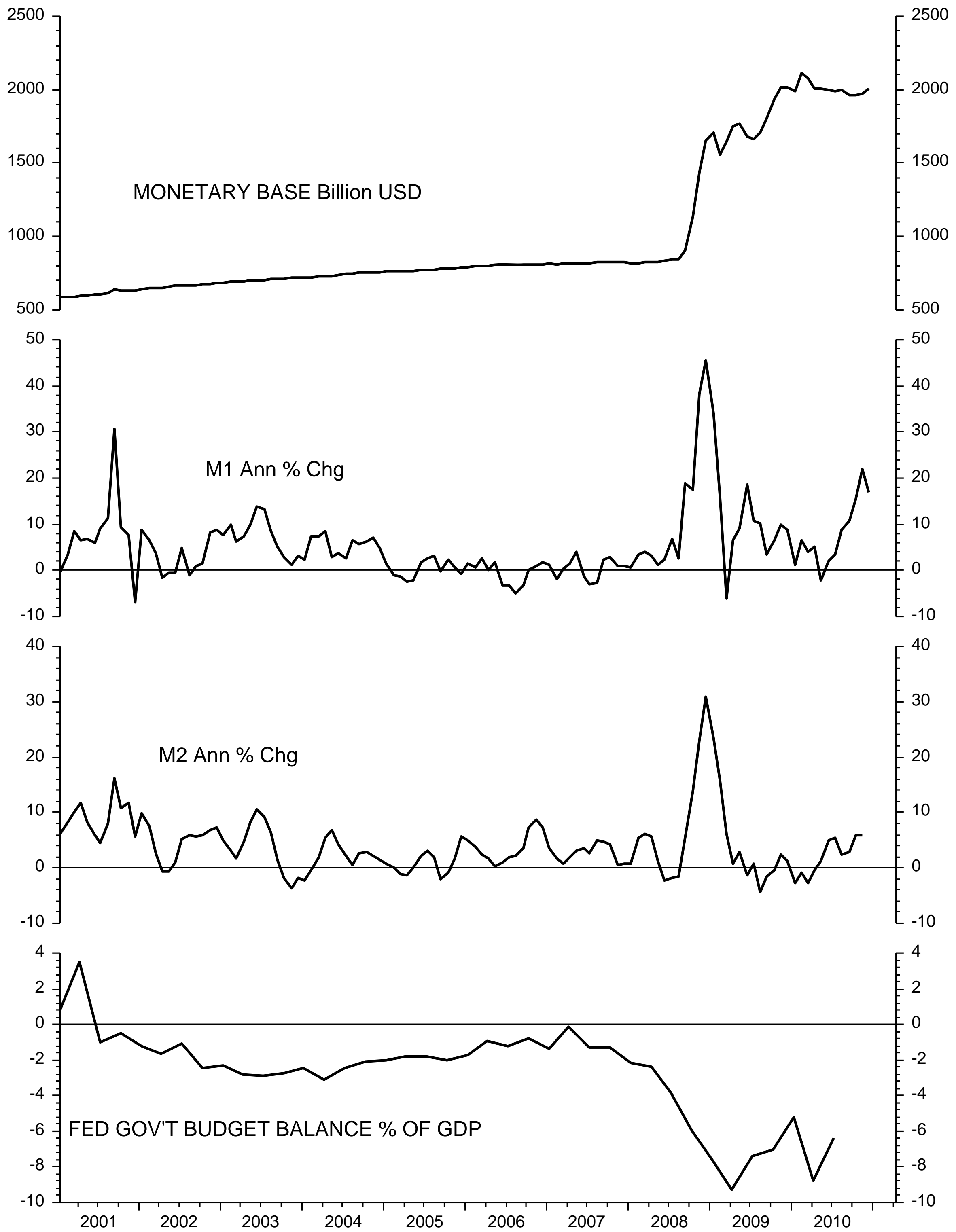

COMMODITIES
1 & 2 Quarter Moving Averages
Crude Oil-WTI Spot Cushing U$/BBL
Natural Gas-Henry Hub $/MMBTU
Coal SA ARA CIF US$/MT
160
140
120
100
80
60
40
20
10
8
6
4
2
1
300
200
90
70
50
2006
2007
2008
2009
2010
Source: Thomson Reuters Datastream

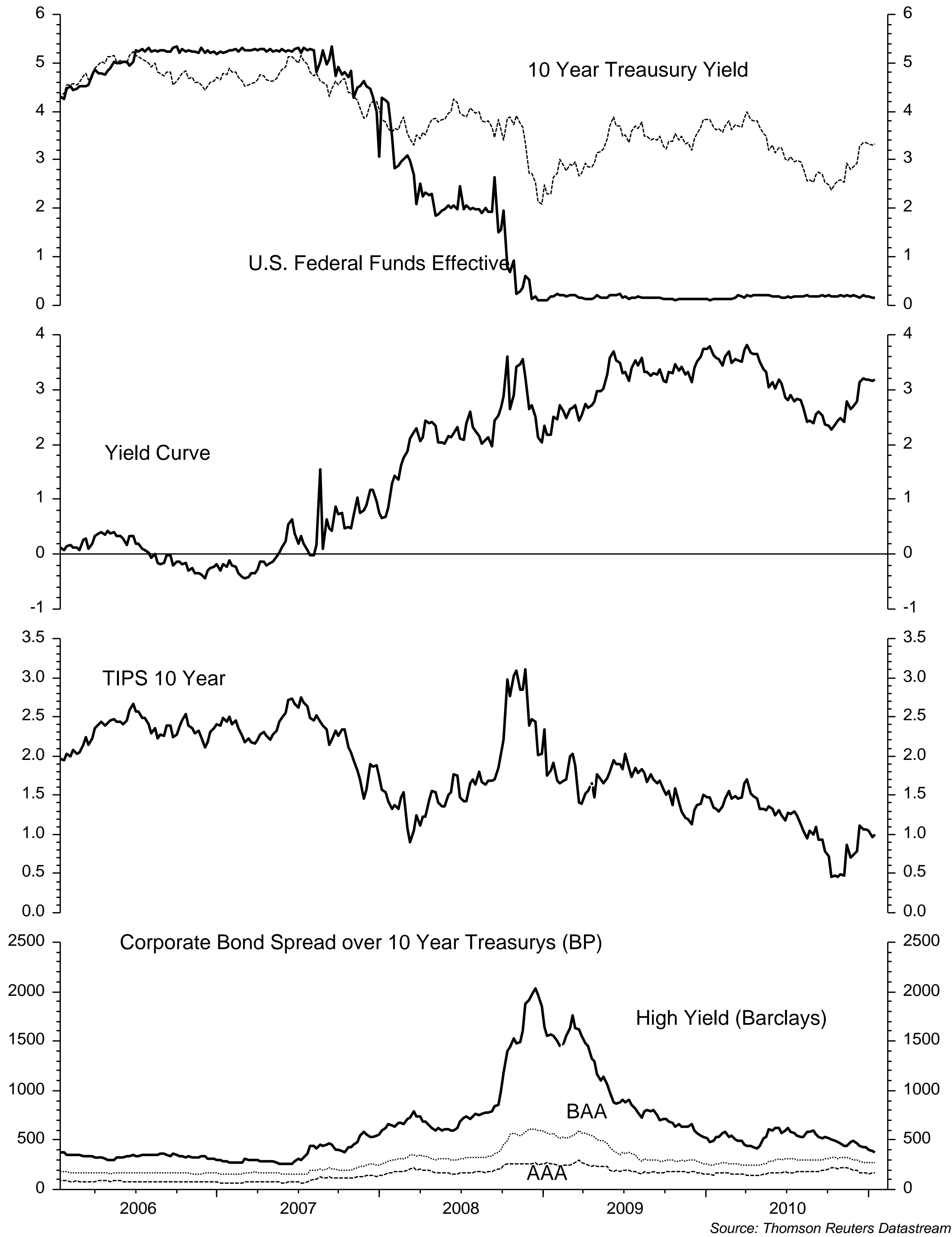

COMMODITIES
1 & 2 Quarter Moving Averages
Latest: 14/01/2011
Gold Bullion LBM U$/Troy Ounce
1600
1400
1200
1000
800
600
Silver Fix LBM Cash Cents/Troy ounce
3500
3000
2500
2000
1500
1000
Uranium UxC-Ux U3O8 Spot U$/LB
70
65
60
55
50
45
40
2009
2010
Source: Thomson Reuters Datastream

EXCHANGE RATES

Latest: 14/01/2011

Source: Thomson Reuters Datastream


U.S. MONEY SUPPLY
MONETARY BASE Billion USD
M1 Ann % Chg
M2 Ann % Chg
FED GOV'T BUDGET BALANCE % OF GDP
2001
2002
2003
2004
2005
2006
2007
2008
2009
2010
Source: Thomson Reuters Datastream


INTEREST RATES
Latest: 14/01/2011
10 Year Treausury Yield
U.S. Federal Funds Effective
Yield Curve
TIPS 10 Year
Corporate Bond Spread over 10 Year Treasurys (BP)
High Yield (Barclays)
BAA
AAA
2006
2007
2008
2009
2010
Source: Thomson Reuters Datastream