

## *Are You Ready for Another Lost Decade?*

In April 2003 we published an article which posed the question, “Whither the secular Trend of Equities?” This piece laid out the case that the year 2000 was a secular or “long-term” peak for the U.S. stock market. The article also forecast that equity prices would experience a wide multi-year trading range as sentiment unwound from the unrealistic assumptions that pushed price earnings ratios and dividend yields to record extremes. Many investors and members of the financial press are only now recognizing that stock prices have lost ground over the last 10 years, labeling this period as the “Lost Decade.” Not only have equities been unable to make any net progress in that time, but they have actually lost value in purchasing power terms. Given the sharp 2009 rally, one of the strongest on record, it makes sense to re-open the question of whether investors should revert to a buy hold approach or continue to apply the tactical asset allocation strategy that has worked so well in the last 10 years. Before we address that question, let us first define what we mean by a secular trend.

### **What is a Secular Trend?**

A long-term secular trend is formed when a series of business cycles are linked together establishing extended periods of stock market out- or under-performance. These long-term secular price trends last up to 20 years and sometimes more. Investors need to correctly identify the direction of the prevailing secular trend if they are to successfully protect and grow wealth. That is because the tide of a secular bull market lifts all boats as investors are quickly bailed out of their mistakes. Anyone who adopts the buy/hold approach might be a temporary hero but the secular bear proves that the emperor has no clothes. Risky strategies may work in a secular bull market, but only defensive cautious ones will enable you to preserve real purchasing power during a secular bear.

Chart 1 shows the course of the US stock market since 1800 and the solid and dashed waves approximate the secular trends in this absolute price series. Occasionally these bear markets, such as the ones that developed between 1901-20 and 1966-82 look benign. However, from an investor’s long-term perspective real purchasing power is more important. For example, you may see the value of your portfolio jump by 15%, but if inflation takes away 20%, you are actually left 5% worse off in the amount of goods and services your portfolio can purchase, not to mention the tax on your “gain.” Inflation then, is a stealth tax on your returns. Since the damage in real purchasing power terms is a serious one, we prefer to express prices in inflation adjusted terms when considering secular trends. Another reason is that inflation-adjusted prices make these long-term swings easier to identify. This is demonstrated by the declining arrows in Chart 2. The series in the bottom panel shows the track of inflation adjusted profits compared to an inflation adjusted stock market series. Contractions in profitability can explain bear markets associated with the business cycle but not the long-term secular swings. That is because they are purely and simply a function of crowd psychology rather than

economics, though as we shall see later, commodity price inflation plays an important part as well. An example of the dichotomy between real earnings and real prices developed between 1966 and 1982 when earnings rose but stock prices declined by more than half.

In the 1940's the legendary analyst Garfield Drew wrote, "Stocks don't sell for what they are worth but for what people think they are worth." This is a very significant observation because it implies that it is not earnings that are important, but people's attitude to those earnings that is key to the pricing of equities. An understanding of the secular trend is an appreciation of the fact that investors are continually undergoing long-term psychological mood swings, similar to the swing of a pendulum in a clock.

It is a fact that the longer a specific trend or condition exists, the more comfortable we become with it. Investors are cautious at the start of a bull market secular trend because they are mindful of the previous bear market disaster. Gradually, confidence builds as each successive bull market returns greater and greater profits. Eventually market



Chart 1

## S&P Composite Deflated by CPI and Real Earnings (Shiller)

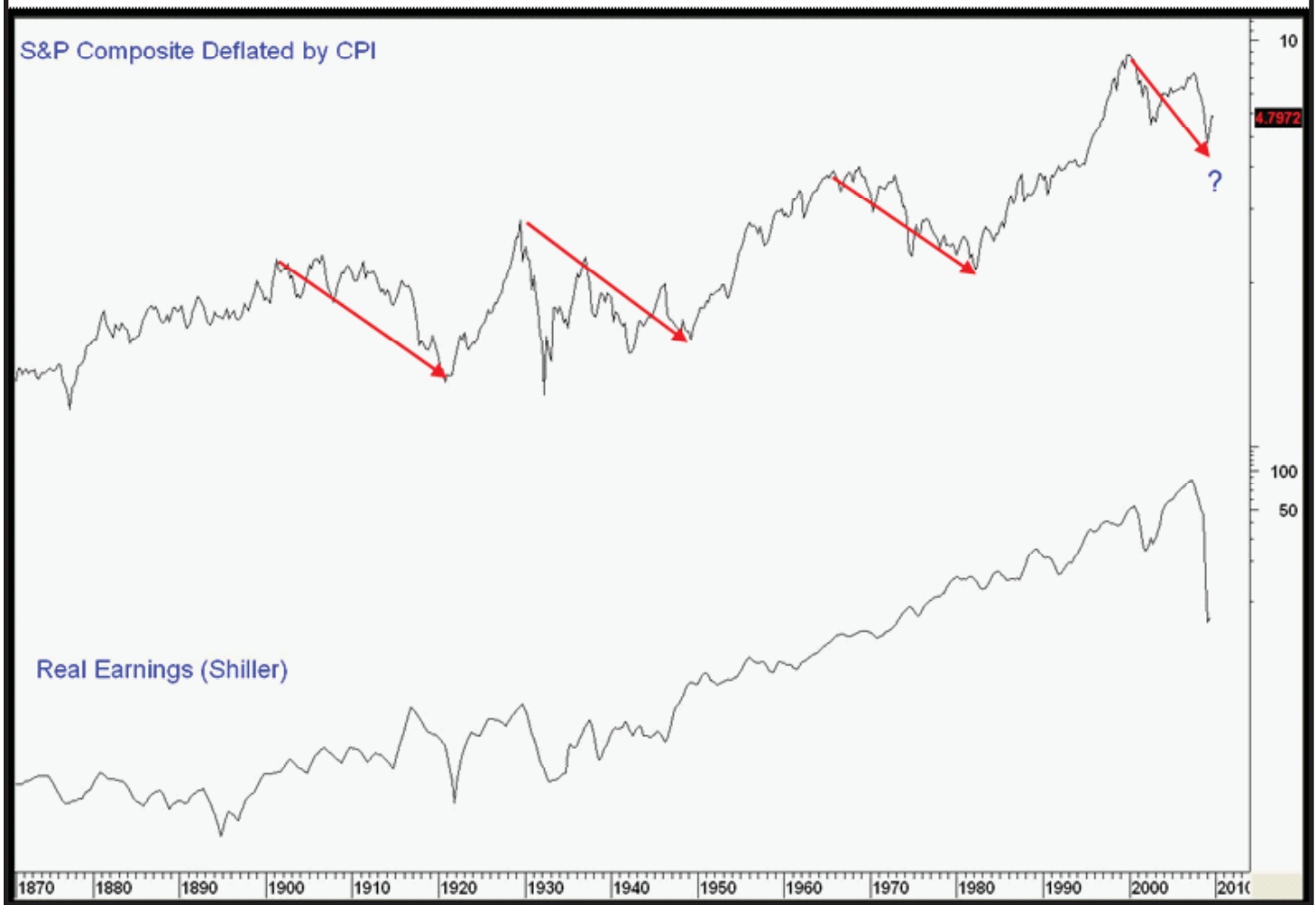


Chart 2

participants fall victim to careless decisions as they are sucked in by their own success and egged on by an ever more optimistic crowd around them. The secular bear market is not caused by the unwinding of these careless investment decisions alone because they can easily be corrected during the course of the ensuing primary bear market. The secular bear is more structural in nature as distortions arise in areas beyond the equity market. Each cycle is characterized by its own excesses. It was canals in the early part of the nineteenth century, railroads in the 1870's, manufacturing in 1929, technology in 1999, housing in 2007, and so forth. One of the byproducts of a skyrocketing stock market is the ability of firms to raise cheap capital. This not only results in risky mergers and acquisitions but excess manufacturing and industrial capacity. Consequently, companies are precluded from fully recovering until this surplus has been worked off or written down. The previous secular bull, with its backdrop of growing confidence, also embraces fraudulent behavior, which is masked during the great investment boom. When prices "unexpectedly" start to slip and credit is no longer available, such schemes and scams are quickly exposed. Governments and financial institutions play their part; of course, as the stringent rules developed as a legacy of the previous bear are gradually relaxed during the uptrend and then rigorously reapplied during the downtrend. In this respect, the rush to find scapegoats supersedes common sense and prudence. Politicians are a lagging indicator, so it is natural for them to respond to the unrest fomented by the

downtrend. The problem is that these kneejerk reactions lead to policy mistakes, and though intended to help, actually make the situation worse. Higher taxes, the Smoot Hawley tariff, and competitive devaluations were all characteristics of 1930's style policy errors. Exponentially rising government deficits and the threat of massive tax increases loom as prospective policy mistakes for the immediate future. Absent a course correction, bankrupt Medicare, and Social Security entitlements represent icing on the bearish cake. Left to their own devices individuals would solve these kinds of problems by restructuring their balance sheets, paying off debt, etc. Unfortunately, current policy solutions are moving in exactly the opposite direction.

## Characteristics of Previous Secular Bear Markets and Where We Are Today

Secular bear markets are characterized by several factors. The most important is a complete reversal in psychology from the euphoria and over confidence of the previous secular bull, to one of total disgust with equities by the time the bear has run its course. Unfortunately this is not an overnight process, but requires prices to experience a huge drop over an extended period. The large decline is obviously discouraging as investors see their wealth being slowly eroded. However, it is the extended duration of the drop in real purchasing power that slowly eats away at the confidence of even the most optimistic investors. Experience has shown that in order to correct the structural distortions built up in the previous secular bull, it was normal for the economy to undergo between four and six recessions before the bear is finally laid to rest.

We'll examine the psychological aspects first by considering valuation, not as a fundamental measure, but as one of sentiment. Arguably the most popular long-term measure of stock market valuation is the price investors are willing to pay for corporate earnings. Why at one time are fearful investors only willing to pay \$6.64 for \$1 of earnings, (i.e. 1982 Secular Bottom) while at another time investors are eager to pay \$44.20 for that same \$1 of earnings (i.e. 2000 Secular Peak)? The answer lies in the extremes of confidence or lack thereof only seen at major secular turning points.

Take a moment to look at the Shiller P/E series at the bottom of Chart 3\*. The key turning points are summarized in Table 1. Notice that at the beginning of secular bear markets the average P/E ratio is 31.5; in contrast the average at the end of these periods is 6.95. The current (October 2009) Shiller P/E reading is 18.77. We may have traveled a long way from the 2000 historic overvaluation peak (P/E 44) but clearly there is a long way to go to reach truly undervalued levels once again.

Chart 4 shows a similar comparison, but this time with the inverted dividend yield. The secular swings are not so obvious but the turning points are all associated with extremes in valuation. When investors are optimistic they are willing to settle for a paltry 2-3% yield, but when it comes to a secular low, they require a much more generous payout in the 6-7% range. The current November 2009 reading just over 2% is a long way from the average at secular lows of 7%.

\* Noted Economist Robert Shiller uses a proprietary 10-year average P/E ratio to smooth out the volatile business cycle effects on earnings. This data can be found at <http://www.econ.yale.edu/~shiller/data.htm>.

## US Stock Prices CPI Adjusted and Shiller's P/E Ratio



Chart 3

		Duration	# of Recessions	Starting P/E	Finishing P/E	Decline (Inf Adj)
1	1901-1920	19 Yrs 6 Months	6	25.24	5.13	-69%
2	1929-1949	19 Yrs 9 Months	4	32.56	9.07	-67%
3	1966-1982	16 Yrs 6 Months	4	24.06	6.64	-62%
	<b>Average</b>	<b>18 Yrs 7 Months</b>	<b>4.67</b>	<b>31.52</b>	<b>6.95</b>	<b>-66%</b>
4	2000-Present	9 Yrs 7 Months	2	44.20	?	?

Table 1

# US Stock Prices CPI Adjusted and the Dividend Yield (Inverted)

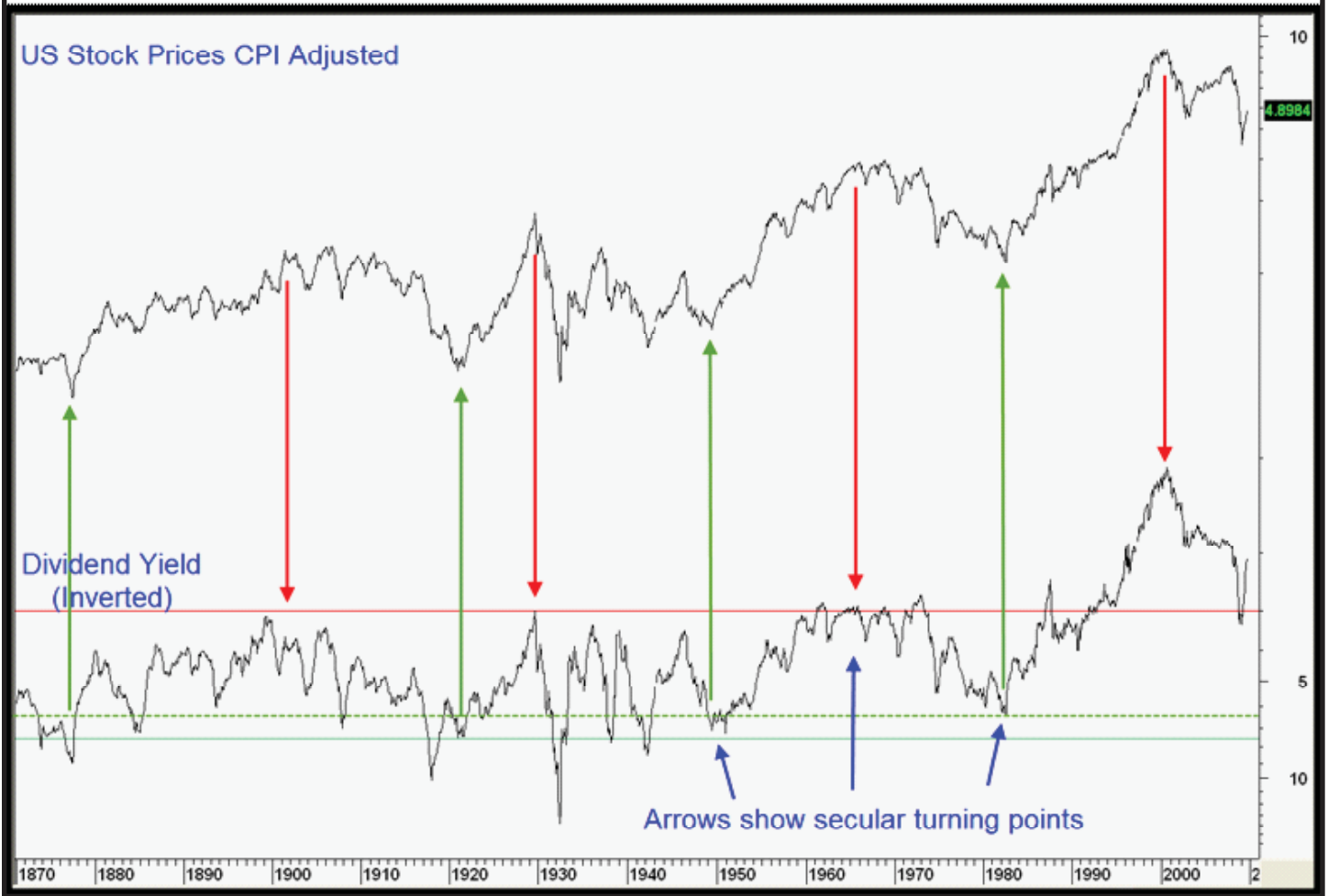


Chart 4

# Tobin's Q Ratio, 1900 - 2009

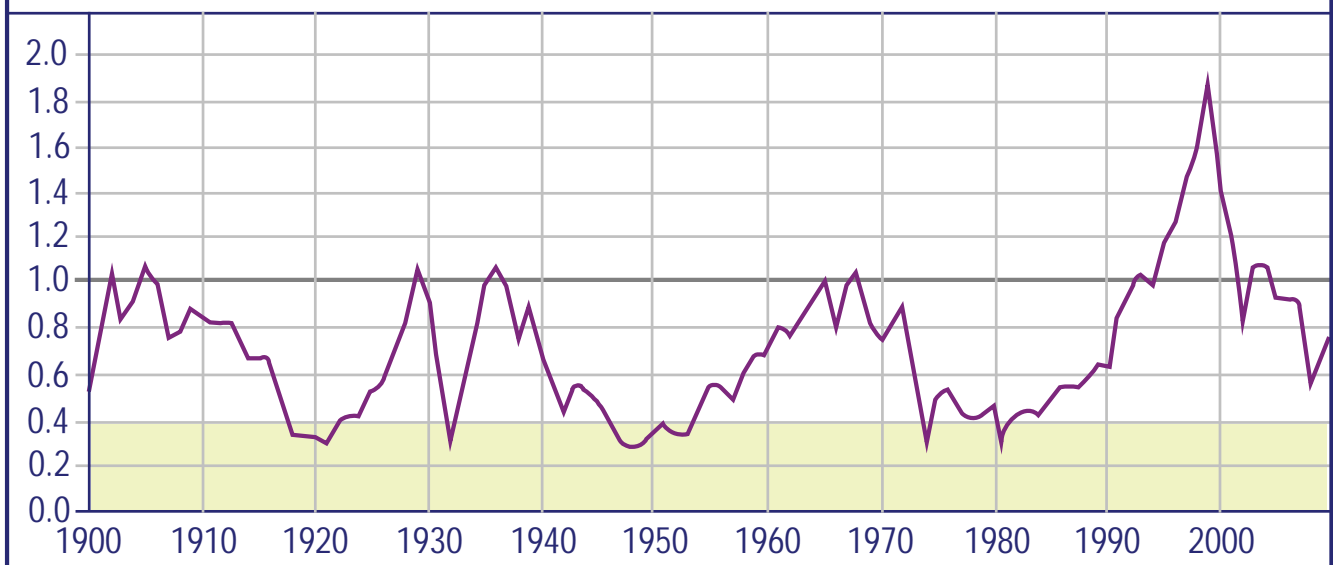


Chart 5

Another method of measuring valuation value was created by Yale economics professor and Nobel Laureate James Tobin, hence the name Tobin's Q ratio. The Q ratio (Chart 5) measures the fair value of the stock market. It is defined as the total price of the market divided by net worth measured at replacement cost. A value greater than one indicates stock prices sell above their replacement cost and are therefore expensive while a reading below it tells us that the market can be bought for less than replacement cost. A ratio well below one indicates that it is cheaper to buy a company than to build one. A long term look at the Q ratio gives investors a good understanding of value, information about current risk levels and a method to assess probable returns for the long term. Secular bear markets generally bottom when the ratio declines to a bargain level of less than .4, or when stock prices sell for just 40% of replacement value. The 2009 third quarter reading was .78, which was considerably higher than the average secular low of .32.

## Does Inflation Have an Effect on the Secular Trend?

The long-term trend of commodity prices appears to have an enormous effect on the direction of the secular trend of stock prices adjusted for the CPI. This relationship is shown quite clearly in Chart 6. The series in the upper panel represents stock prices deflated by the CPI since 1871 and industrial commodity prices prior to that date. The secular bear markets since 1850 have been flagged with the dashed red arrows. It is fairly evident that all of them have been associated with a background of rising commodity prices. The relationship is not an exact tick by tick correlation but the chart clearly demonstrates that a sustained trend of rising commodity prices sooner or later results in the demise of equities. There was one exception to this relationship and that developed in the 1929-32 bear market where commodities and equities both fell due to the collapsing economy. After that, sharply rising commodities resulted in a trading range for equities until 1949. By the same token, the solid green arrows show that a sustained trend of falling or stable commodity prices is positive for equities as all six secular bulls developed under such an environment. This point is also underscored by the opening decade of the last century. It has been labeled a secular bear, but real equity prices were initially quite stable as they were able to shrug off the gentle rise in commodities. Only when commodity prices accelerated to the upside a few years later did stock prices adjusted for inflation sell off sharply.

A useful approach for identifying a secular peak in commodity prices and therefore secular low in equities is to calculate a price oscillator or trend deviation measure. In this case, the parameters used are a 24-month (2-year) simple moving average divided by a 240-month (20-year) average. The downward pointing arrows indicate that reversals from an overextended position have offered four reliable signals in the last 150 years or so. The oscillator also peaked in 1975 but this proved to be a temporary respite for both the secular equity bear and the commodity bull market. The indicator reversed direction last year and this could be a signal of a secular commodity peak. However, gold leads commodities and has recently been hitting new all-time highs. In addition, pretty well all of our business cycle associated commodity indicators are in the early stages of a primary bull market. We are therefore expecting the secular trend of industrial commodity prices to extend.

## Magnitude and Duration

In freely traded markets the size of any particular mood change is often related to the level and extent of emotion experienced in the previous trend. Thus, it is normal for a 4- 6-week rally to be followed by a 2- 3-week correction or a primary bull market lasting two years to be followed by a bear lasting one year. The swing to the downside can be roughly

## Stock/Commodity/CPI Ratio and Two Indicators

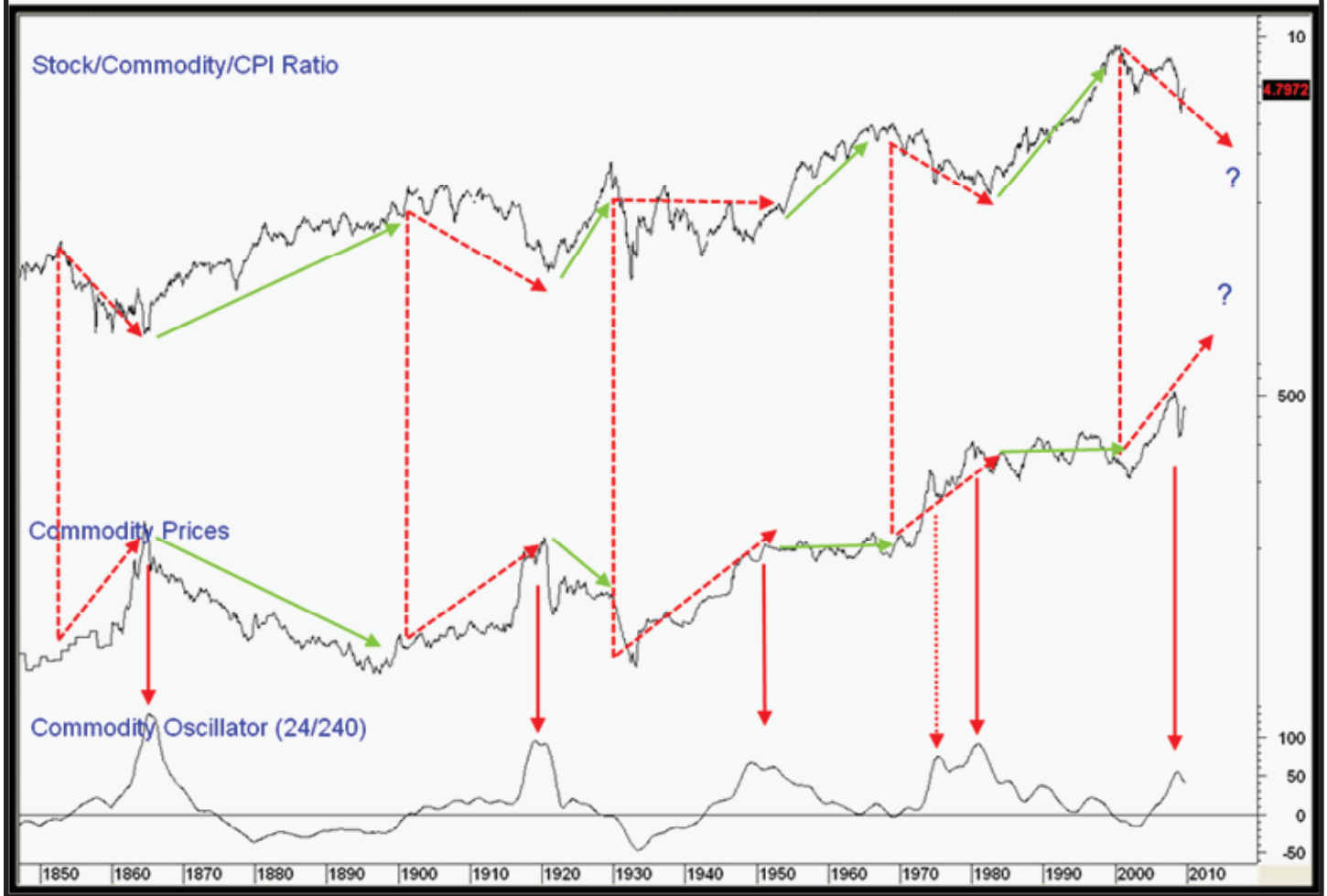


Chart 6

proportionate, but since it takes longer to build than to tear down, bear moves normally take less time to unfold. The previous secular low in absolute prices developed in 1974 and the high was registered in 2000; a 26-year record secular bull run. That fact, together with the record levels of overvaluation in 2000, suggests that the current secular bear will be greater in magnitude and duration than the average.

Previous post 1900 inflation adjusted secular bear markets have lasted for about 18-20 years. This was true for the 1901-20 and 1966-82 bears, but only works for the post 1929 drop if we regard the period between 1932 and 1949 as a trading range. Indeed, in 1949 inflation adjusted prices were not much above the 1932 low and neither was the P/E multiple. Taking the year 2000 as our peak, even allowing the best (shortest) case 16-year bear between 1966-82, would project a low seven years hence in 2016.

Chart 7 shows these previous giant bears in an overlay form. We have obviously come a long way in terms of magnitude, but a projection based on the average duration of these and the current Japanese long-term bear (1990-200?) would suggest that a new secular bull will not emerge until at least two more cycles have transpired. A simple approach

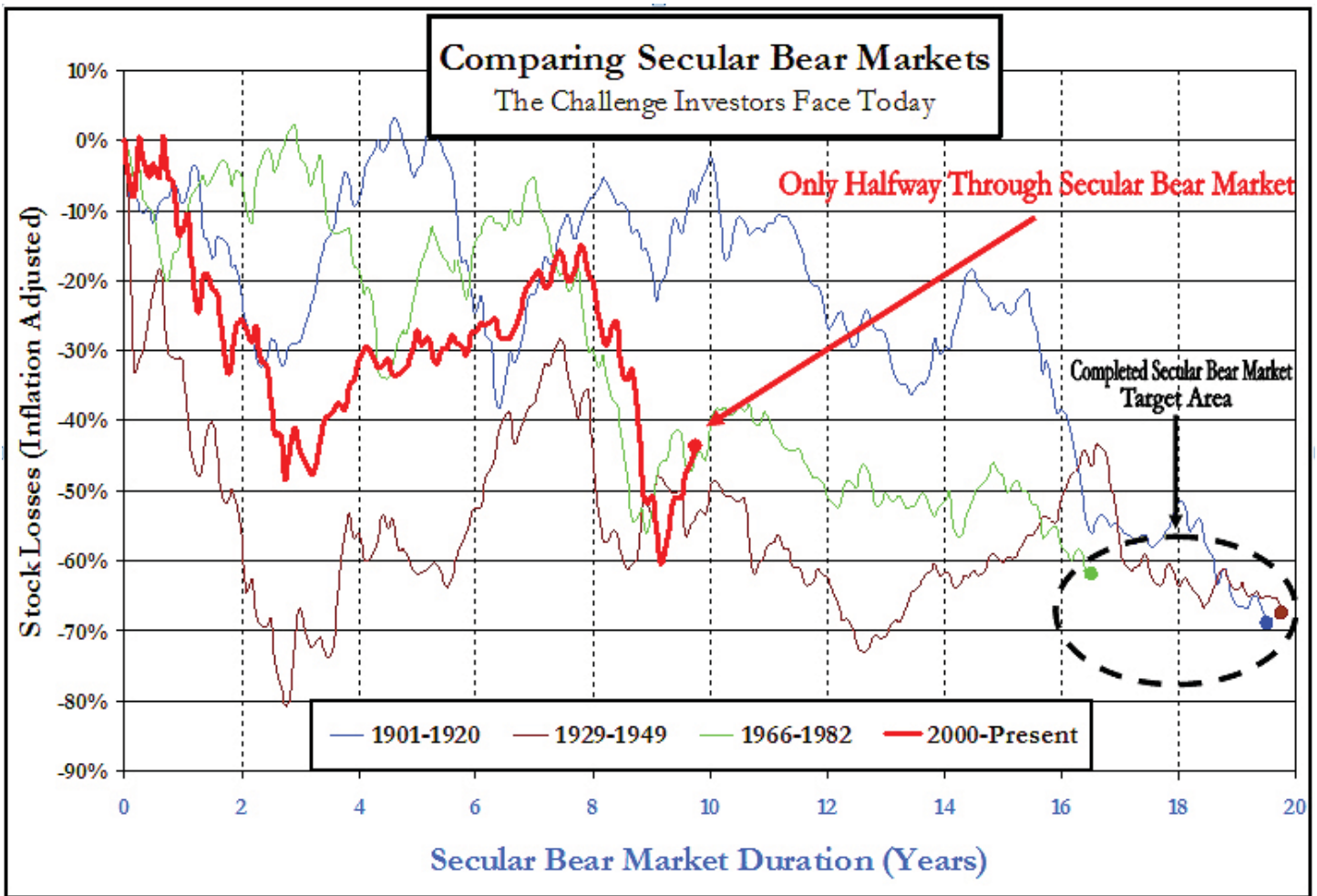


Chart 7

that measures the stamina of investor psychology; i.e., the ability to take knocks and come out fighting again, comes from the number of recessions required to complete a secular bear market involves the number of recessions required to correct the previous bullish excesses. In prior secular bear trends, this has averaged between four and six. Only two economic contractions have been experienced since the year 2000. Allowing that best case scenario of four recessions would again suggest that we are barely half way through the current secular bear cycle. Recessions have been flagged in Chart 3 by the red highlights.

Our final point concerning duration is featured in Chart 8. The blue waves in the bottom panel indicate price swings in excess of 25%. As you can see, two previous cycles experienced seven such waves and the most recent 1966-82 bear traced out five. Three complete waves have been registered so far and we are currently experiencing the fourth. Once the current bull market has run its course, wave 4-5 should begin and that has traditionally been one of the more severe (not a forecast, merely an observation).



Chart 8

## What About the Rest of the World?

The leading indicator of secular bear markets is Japan. Chart 9 indicates that it has met the average US magnitude and duration standards. The decline, in inflation adjusted terms, has already chopped off 80% from the peak value set in 1990. You can also see that if 40% price swings are considered the market has experienced seven waves. If the 25% standard applied for the US market in Chart 7 is used, then nine waves have been completed. Indeed, by way of showing how poor Japanese performance has been, current CPI adjusted prices for the Nikkei are not far above 1963 levels.

Chart 10 compares this CPI adjusted Nikkei with that of the S&P. In this case, the S&P data has been lagged by 126 months so that the two secular peaks coincide. The waves in the lower panel compare the progress of these two series in a more simplistic way. Obviously, they are not identical, but what is striking is the fact that the two trading patterns are so close. The dashed green waves represent future S&P action should it continue to correspond with that of Japan. This is certainly not a forecast, but if the paths turned out to be similar, this projection would call for a peak in the summer of next year. After that, the next bear market would be projected to end 2013. Japan certainly needs to be closely monitored for it could well prove to be a very early leader for the next secular bull market.

### Nikkei Inflation Adjusted vs. Waves in Excess of 40%

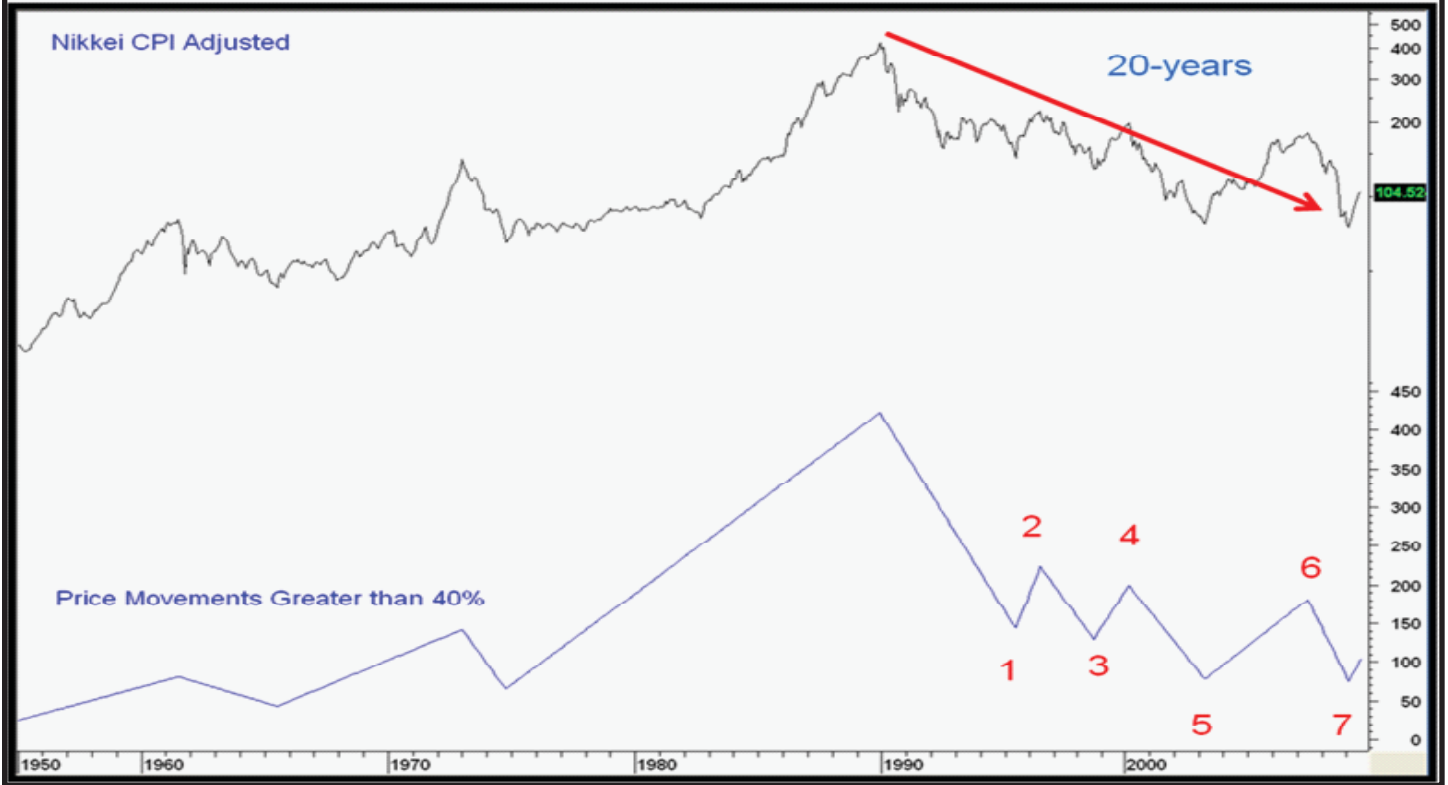


Chart 9

### S&P Composite (CPI Adjusted) and Nikkei (CPI Adjusted)

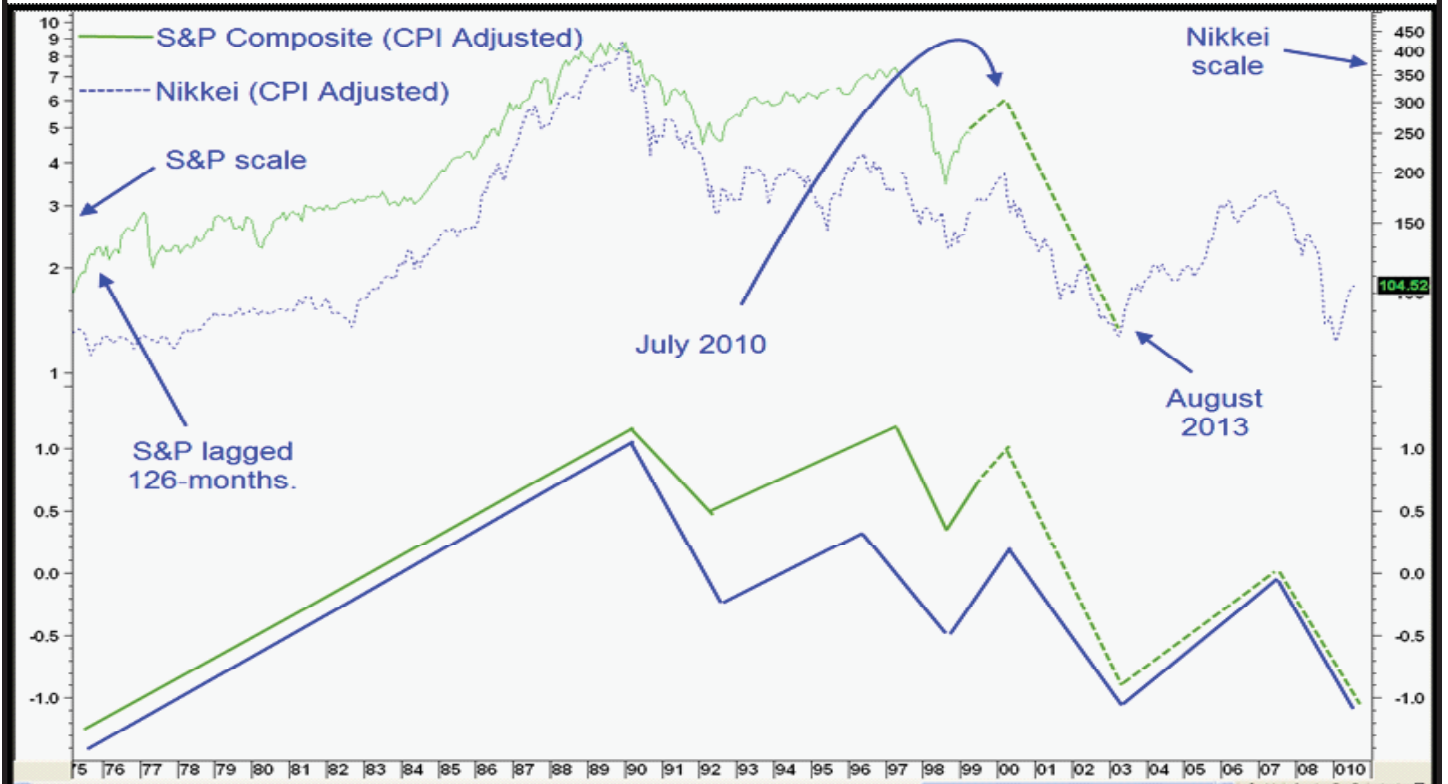


Chart 10

Many may be wondering about China and the great promise it holds. After all, this market peaked in 1997 several years after the US. Chart 11 shows that the Shanghai Index experienced a bubble of its own. This evidenced by the extremely high reading in the 18-month rate of change in the lower panel. Two other bubble peak readings are also shown, that for gold in 1980, and the NASDAQ in 2000. Shanghai in 2007 was greater than either of them. Experience with many other markets tells us that reversals from readings of this nature are either followed by a long-term decline or a multi-year trading range. There have been exceptions to this rule, but they are few and far between.

## Where is the Bottom?

Secular trends in equity prices are very much tied to psychology, which itself is continually fluctuating between euphoria to extreme pessimism; just like the swinging pendulum of a clock. This psychological pendulum is much slower to reach its extremes averaging something like 20 years. Using previous secular lows as our guide it is possible to establish benchmarks that can help us pinpoint where we are today (November 2009) and what needs to happen in

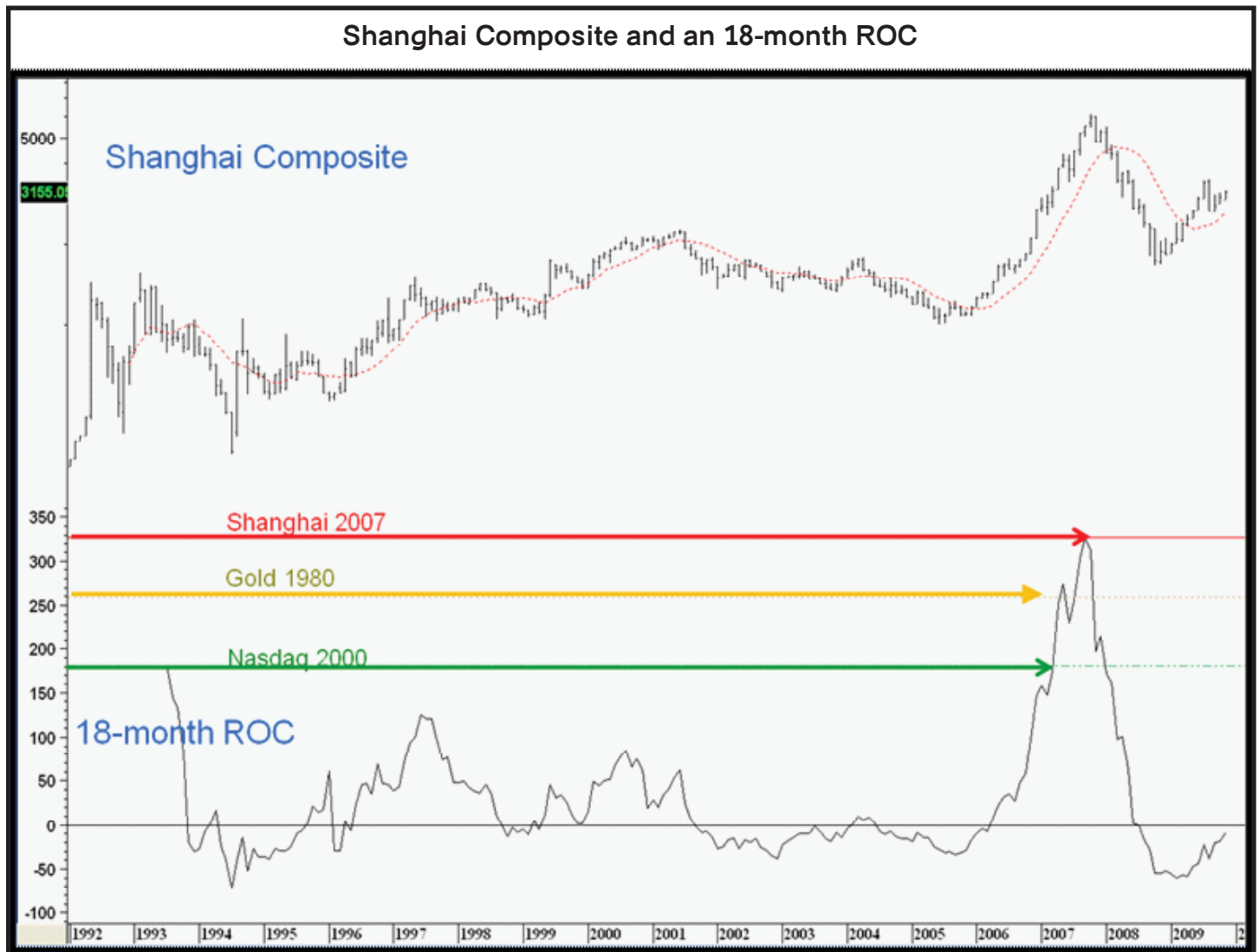


Chart 11

order to signal a new secular bull market. That is where Figure 1 comes in. The left X axis measures the magnitude of the losses experienced during a secular bear market and the Y axis the time taken to complete it. The right X axis represents valuation for both price/earnings ratios and dividend yields on a percentile basis. Thus a 10% percentile represents a price earnings ratio that falls in the top 10% of all monthly observations since 1871, or a dividend yield that falls in the bottom 10%. High percentiles represent good value and low ones tell us that equities are expensive. The numbers contained in the figure tell us the actual P/E or dividend yields for the three periods. Using the Y and left-hand X axis the letters “DM” are positioned to show the duration and magnitude of the current and average secular bear markets, respectively.

By way of a cautionary note, it is important to stress that there are no known techniques for consistently forecasting the magnitude and duration of any price move. The following numbers should therefore be used as an approximate guide. It is fair to say though, that by any yardstick, current readings are a long way from previous experience at secular bear market lows.

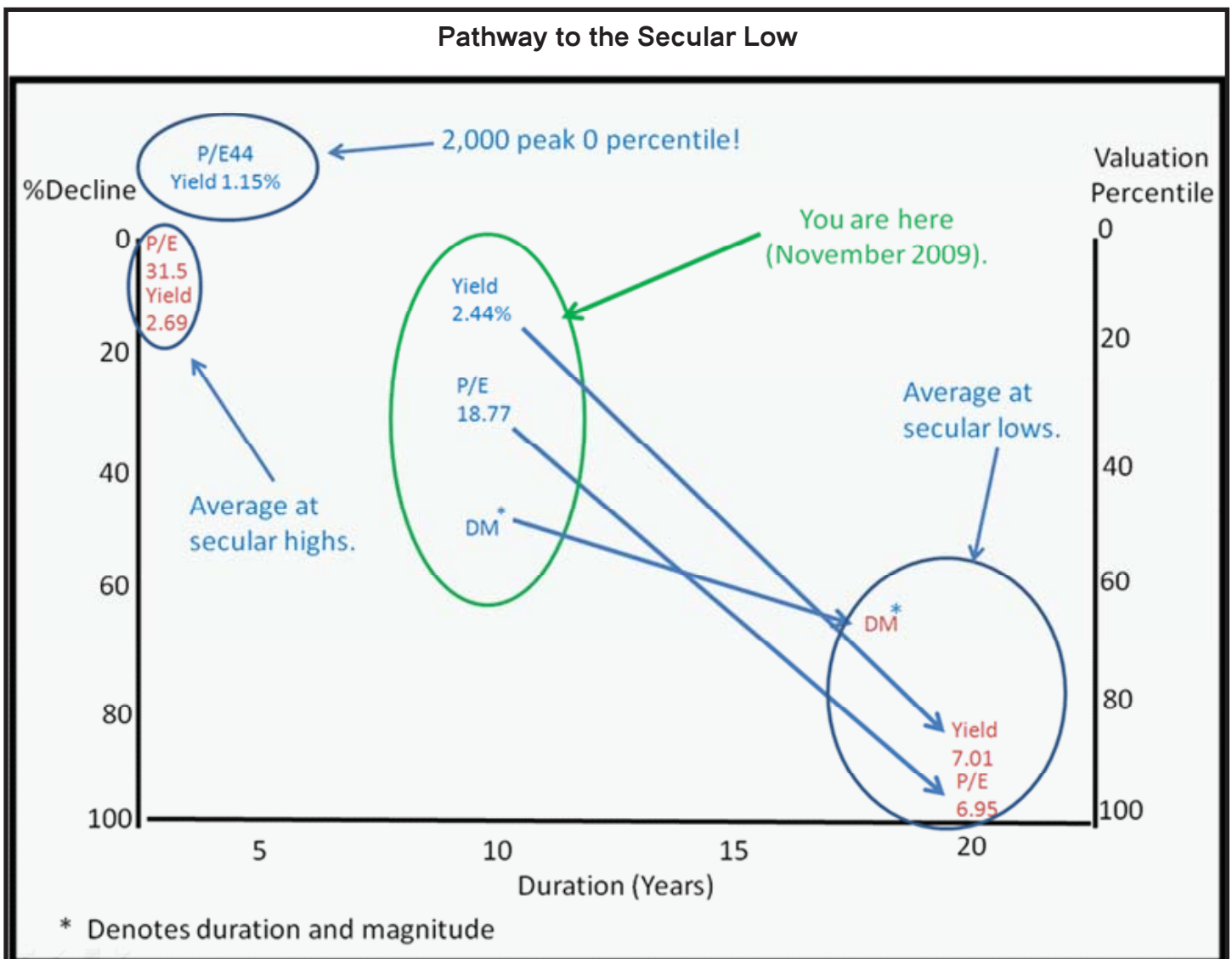


Figure 1

Our forecast calls for an extended trading range with a downward bias but we cannot rule out the possibility that in terms of absolute prices the secular low may have already been seen in a similar way to the 1932-49 and 1966-82 experiences. Whether it is a trading range or a real bear market, the important point is that the investment challenges in the years ahead are likely to be formidable. Dow 35,000 was a popular title at the 2000 peak. May we suggest Dow 2,500 as an equally flawed title for the low?

## Is it Possible to Build Wealth during a Secular Bear Market?

It is possible to build wealth during a secular bear market, but investors must first discard the buy and hold, indexing, and passive asset allocation strategies that worked so well in the prior secular bull market. In a negative secular environment the same static methods result in severely inadequate returns. The crucial determinant to wealth-building success in a secular bear market is to adopt a more pro-active plan of action. Even in this difficult overall negative atmosphere, there will be rewarding opportunities. The cyclical bull market that began in March 2009 is a typical example. Others, with moves in excess of 25%, have been flagged in Chart 8. These primary bull markets reflect the normal transition of a business cycle from economic recession to expansion. The key to their successful exploitation is the application of the proper business cycle forecasting tools and disciplines.

To give you an idea of the kind of challenges faced by investors in a secular bear market, it is worth noting that the last secular bull market (1982-2000) covered 18 years but contained only 2 recessions lasting a total of 12 months—that is less than 6% of the time. Compare that to the last 10 years in which the secular bear market experienced 2 recessions lasting a total of 28 months, or about 27% of the time. That is far closer to the US experience of the past 150

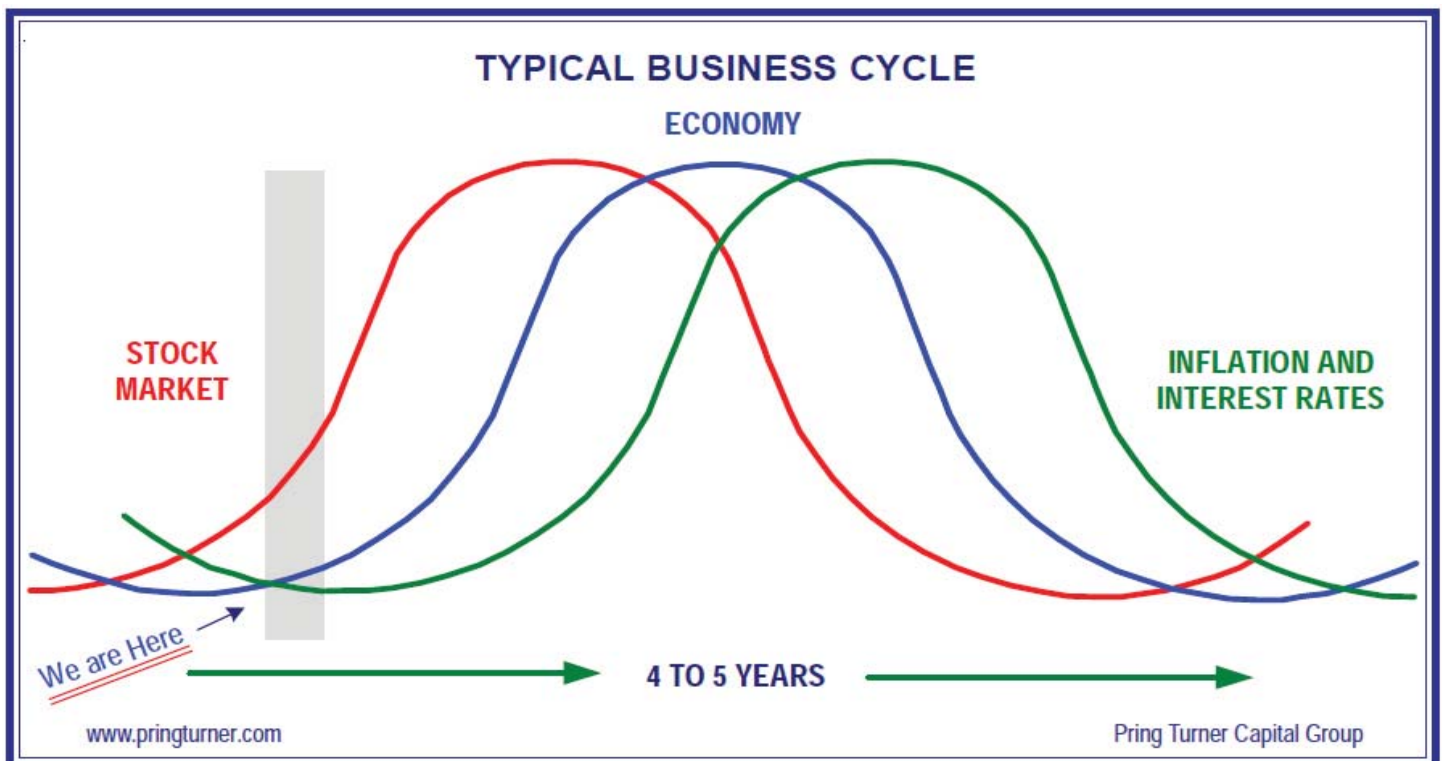


Figure 2

years, where the economy spent an average 31% of the time in recession. If the lessons of previous secular bear markets play out, then the next 10 years will experience increased business cycle volatility similar to the 1970's. Since recoveries will be briefer and contractions more extended, investors will need to be more nimble and opportunistic during bull markets and far more defensive during the longer periods of economic downturn.

The last 150 years of economic and financial history show that markets are linked in a logical way to business activity. The economy goes through a set series of chronological sequences just like the seasons of the year. Recognizing these "seasons" and correctly applying the appropriate asset allocation have always had a beneficial impact on investment returns. Figure 2 shows an idealized business cycle and is intended as an investor roadmap that helps drive important tactical asset allocation decisions as the business cycle unfolds.

As to the current business cycle position, Figure 2 shows that the stock market has been rising up for nine months, while the economy is just now coming out of a deep recession. For their part, interest rates and inflation are near their lowest levels of the cycle. The shaded area flags where we are today, so stocks can be expected to continue to do well as economic growth strengthens. Ultimately, interest rates and inflation will turn up. Corrections will develop along the way but tactical asset allocation continues to call for portfolio emphasis on stocks. As time progresses, bonds will become vulnerable to heightened risks of interest rate increases. A quick business cycle analysis suggests risk of capital loss for bonds is very high. It is important to remember that even a relatively small increase in interest rates will quickly wipe out the paltry income bonds provide at today's historic low interest rate levels.

## Summary

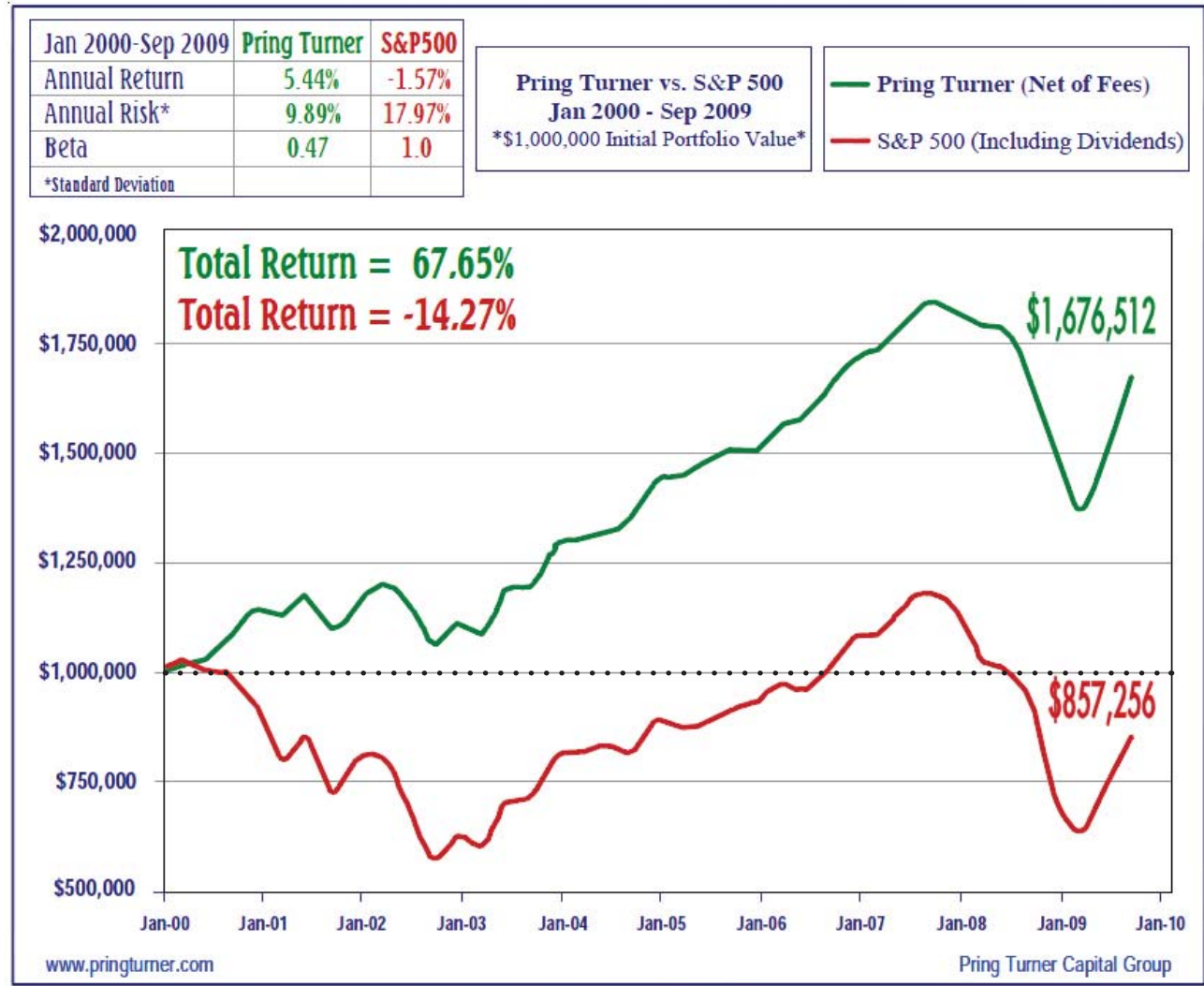
Buy and hold, indexing, and static allocations may work in a secular bull market but they are losing strategies in a secular bear market. Under such an environment it is more important than ever to pay attention to the business cycle for financial success. Essentially, an investor needs two game plans, one for defense, to protect assets in difficult periods and one for offense, to grow wealth during favorable conditions. A prudent and profitable investment strategy should be flexible enough to actively adjust portfolio asset allocation, depending on where we are in the business cycle and the direction of the secular trend. With knowledge of business cycles, secular trends, and tactical asset allocation, it is possible to create better returns with less risk, and most importantly, to experience peace of mind.

Over the next few months, additional articles under the Pring Turner banner (<http://www.pringturner.com/>) will expand on the secular outlook and review tactics and strategies to best capture opportunities and build wealth in the difficult period ahead.

*To view Pring Turner Capital Group's performance, please see page 16.*

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