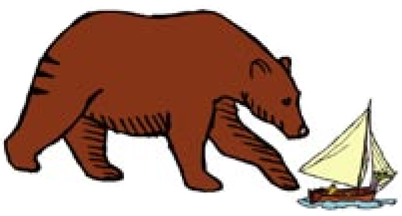
Adjusting Your Sails in Today's Stock Market

by Bill Berner



If one looks at the U.S. stock market over the last 100 years, it becomes apparent that stock valuations swing from undervalued to overvalued, then back to undervalued, only to repeat. There is ample evidence to suggest that these valuation swings are caused more by the expansion and contraction of price-earnings (PE) ratios than the rise and fall of actual earnings. Corporate earnings certainly play a part in these cycles, but less so than the changes in P/E ratios. In other words, how much investors are willing to pay for earnings has a greater effect on the level of stock prices than the earnings themselves. Optimistic investors pay high P/Es historically, while pessimistic investors pay low P/Es.

Generally these cycles of expanding and contracting P/Es have lasted long periods. Along with others, I have come to call periods of expanding P/Es Secular Bull Cycles. The periods of contracting P/Es we call Secular Bear Cycles. By "secular" I mean "a long period," not something in contrast to theological matters.

Since 1900 the U.S. stock market has completed four Secular Bear Cycles and four Secular Bull Cycles. The Bear Cycles lasted 20, 4, 5, and 16 years (average 11.25 years). The Bull Cycles lasted 8, 4, 24 and 18 years (average 13.50 years). The last Secular Bull Cycle ended in 1999 and a new Secular Bear Cycle began in 2000.

The low P/Es at the end of the Bear Cycles were 5, 8, 12 and 9. The high P/Es at the end of the Bull Cycles were 28, 19, 23, and 42.

During the Secular Bear Cycles a little less than half of the years were up for the stock market and a little more than half were down. In the Secular Bull Cycles, a little over 80% of the years were up and less than 20% were down.

Of the four Secular Bear cycles, two periods ended the contraction of P/Es with the market levels near where the period began. The other two bear cycles ended the P/E contraction with the stock market significantly lower than when the period began.

All four Secular Bull Cycles produced a sharply higher level for the stock market when P/E expansion ended.

All eight cycles produced periods when the stock market moved significantly in the opposite direction of the primary trend.

I believe there are numerous useful lessons that investors can take away from this information. I'll mention a few.

1. Secular Bull Cycles offer significant profit potential. Secular Bear periods are difficult, at best.

2. "Buy and Hold" strategies are one type of strategy that can be successful in Bull periods. "Buy and Hold" strategies have the potential to be a disaster during a Bear Cycle.

3. These Secular Cycles have usually lasted a long time, on average about 12 years. The three shortest periods occurred between 1929 and 1941.

4. In the Bullish Cycles the P/Es have gone to roughly 20 or higher. In the Bearish Cycles, the P/Es have gone to roughly 10 or lower.

5. In each cycle there are periods when the stock market moves contrary to the longer term Secular trend. It is not a one way trip.

It is important to note that the actual lows of the stock market during the Secular Bear Cycles usually occurred during the cycle, not at the end when P/Es had completed their contraction. The nearest exceptions to this were the 1929 to 1941 period.

Using history as our guide, what do I take away from the above?

1. Ultimately we are likely to see P/Es near or below 10 for the U.S. stock market. This would be on trailing or reported earnings, not estimates.

2. The current Secular Bear Cycle probably has several years to go to completion. There is a good possibility the stock market will see its ultimate low for this cycle before the contraction in P/Es is completed.

3. It seems unlikely that the lows of October 2002 were the lowest levels we'll see in this Secular Bear market. By historical standards neither the P/E level nor the time frame were appropriate. Could it happen? Yes, but there is no historical precedent for it.

4. Investors will likely go from a generally optimistic outlook toward the stock market to a decidedly pessimistic one. That pessimism will help produce the low P/Es which could eventually provide the environment for the next Secular Bull Cycle.

5. Before the current Secular Bear Cycle ends, the stock market will have intermediate periods of both up trends and down trends.

6. A Secular Bear Cycle suggests prudence and caution. Opportunities exist, but special diligence is needed when considering them. A good risk control strategy can be helpful.

The above is not meant to be a "downer," only a history lesson.

The wind is not at our backs, as it was in the 1980s and 1990s.

As William Arthur Wood said: "The pessimist complains about the wind; the optimist expects it to change; the realist adjusts the sails."

The US stock market is sailing in a different weather pattern. Adjust your sails.

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Credits:

John Mauldin, *Bull's Eye Investing: Targeting Real Returns in a Smoke and Mirrors Market.* John Wiley & Sons, 2004.

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