

Whither the Secular Trend of Equities?

Exactly three years and one month ago, we argued that the NASDAQ was rapidly approaching a secular peak. The ultimate potential of the bull market was not known at the time. However, our Chart of the Month showed that the 18-month ROC was at a historically high reading. The speed at which it was rising was unsustainable. So the conclusion, based on the historical precedent of other markets in similar positions, was that the final top was probably less than 90 days away. As it happened, the NASDAQ continued to advance, but only for two weeks. Since then it has lost over 70% of its value and the S&P has declined by 45%. By normal bear market standards enough is enough, but is it? History tells us that it very much depends on the nature of the 2000 top. If it was a normal bull market high then the last three years represents an above average decline in both severity and magnitude that should shortly be followed by

a major bull market. On the other hand, if it was a secular or very long-term peak, then history indicates that the "correction" has barely begun, at least in terms of time.

What is a Secular Peak?

A secular peak is defined as one that cumulates a very long-term advance encompassing several (business cycle associated) bull markets. By their very nature such market turning points involve the kind of overconfidence among investors that is rarely seen and not repeated for a generation, at least. In effect, it is necessary for secular peaks to be separated by sufficient time that people forget the mistakes of the past, and are, therefore, in a position to repeat them. Secular peaks in the stock market can most easily be recognized by extremes in measures of valuation. Indeed, secular trend in equity prices are probably best de-

scribed as very long-term trends in over and under valuation. During this process, investors attitudes swing from excessive and irrational optimism to unjustified pessimism, where disgust with equities becomes so widespread that few, if any, are willing to own them.

Prices in freely traded markets are nothing more than a reflection of crowd psychology and are determined as much by people's attitudes to the emerging fundamentals as the fundamentals themselves.

This means that the psychological pendulum is continually swinging from greed to fear and back again. The size of any particular mood change is a direct function of its predecessor. Thus, a normal bull market takes 9 months to 2 years to develop. The swing to the downside is roughly proportionate, but since it takes longer to build than tear down, bear markets normally take less time to unfold. The previous secular low developed in 1974, so the 26 years of positive price action that developed between then and 2000 will likely take a long time to unwind.

There are two questions that need to be addressed: Did March 2000 represent a secular peak? If so, what are the lessons of the past in terms of the magnitude and duration of the subsequent correction? The second question has already been answered to some degree because the longer and greater the preceding secular advance, the longer the time required to allow the pendulum to swing in the other direction. This rule is not just true for stock markets, but for any freely traded entity.

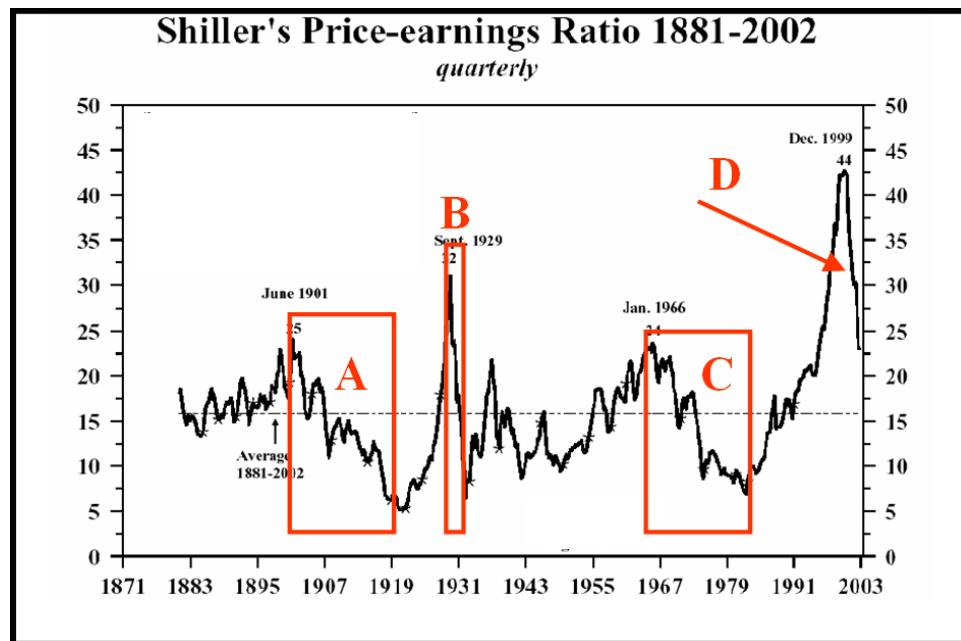


Chart A1 Source: Hoisington Management

Using Fundamentals to Identify Secular Peaks

Since 1900, there have been three secular peaks in the US stock market, 1901, 1929 and 1966. This can be seen in Chart A1, which shows a history of price earnings ratios for the US stock market since 1881. The three boxes indicate the three peaks and the subsequent correction. These periods of overvaluation and the subsequent adjustment are applied to the S&P (Cowles Commission Index prior to 1926) in Chart A2. Each was followed by a substantial correction lasting for many years. The 1901 top was followed by a 20-year trading range. Three subsequent peaks in 1906, 1909, and 1916 were slightly higher than 1901 but it was not and it was not until 1925, 23-years later, that the trading range was decisively penetrated on the upside.

The bear market following the 1929 peak only lasted three years, but was pretty severe with an 85% loss. However, it was not until 1954, 25 years later, that the 1929 high was taken out.

The final peak developed in 1966. It, too, was marginally exceeded in 1969 and 1973. The actual low for the move was achieved 8 years later at the close of 1974. If the market's performance is adjusted for consumer price inflation (Chart A3), it can be seen that the deflated low developed 16 years later in 1982, and the deflated 1966 peak was not bettered until 25 years later in the early 1990's.

The lesson from history is that a secular correction in overvaluation does not necessarily have to be followed by a catastrophic 1929-32 type decline, but the process is usually very long and involved. Its termination is reflected by a total disgust for equities and extremely attractive valuations. The two have to go together, for if there is not a total rejection of equities as a profitable

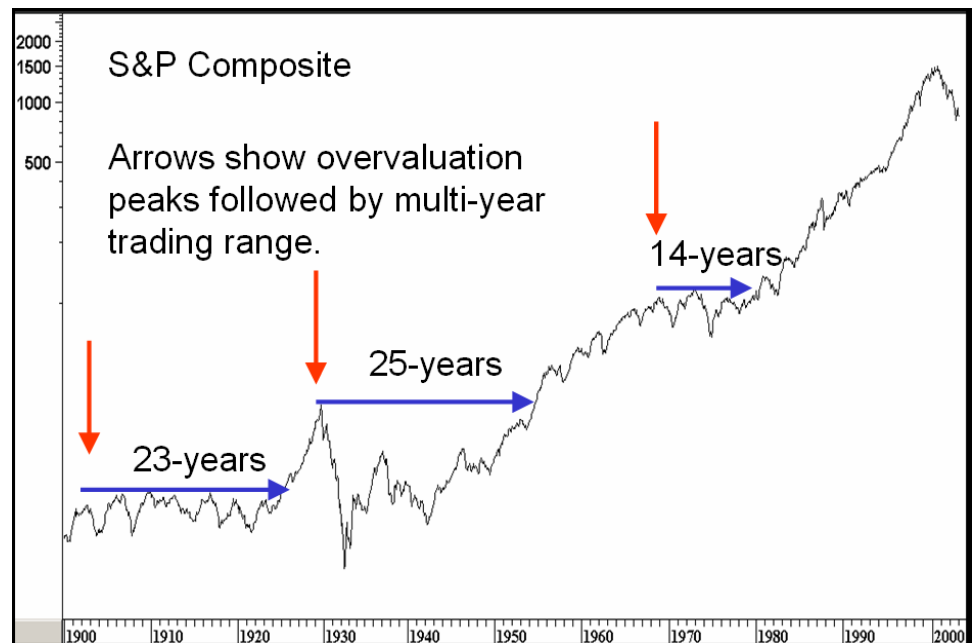


Chart A2

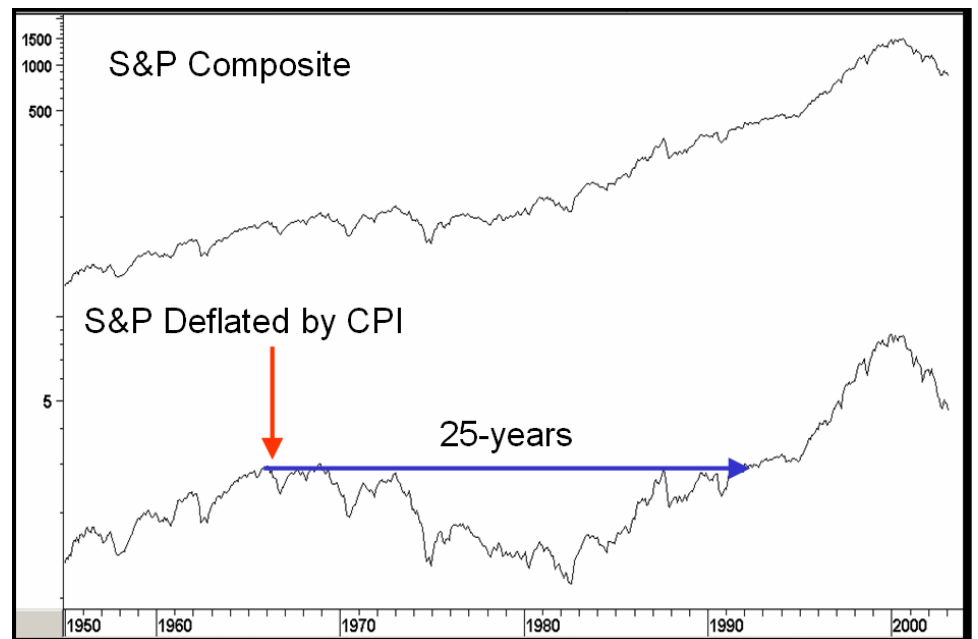


Chart A3

asset class, there can be no fire sale. In effect, people have to be persuaded either by a sharp decline, or a multi-year trading range that equity prices are never going up again, otherwise they would not throw them away at ridiculously attractive prices.

To put the 2000 peak in perspective, the level of overvaluation using the P/E approach dwarfs anything that has gone before, and we are now only three years into

the corrective process. This is even more apparent in Chart A4, which shows dividend yields since the nineteenth century. The up pointing arrows roughly correspond with the secular peaks already described. It is pretty evident that 2000 represents the worst level of overvaluation in the history of the chart. Working on the assumption that attitudes will revert to the norm and beyond, the market clearly has a long way to go. This

could happen with prices coming down, or dividends going up, or prices going sideways and dividends rising or a combination of any of the above. The one unlikely scenario is a sustainable move to new highs.

Using Technical Analysis to Identify Secular Peaks

We have already established that market swings are principally driven by crowd psychology. Consequently, it is a small step to conclude that the oscillators used by market technicians are an ideal technique for monitoring such changes in sentiment. Chart A5, for instance, compares a 10-week MA

of sentiment, in this case bond bulls as monitored by Market Vane, to a 10-week MA of a 14-week RSI. The swings are almost identical, thereby pointing up the close correlation between market sentiment and market momentum. The same exercise can be accomplished for other markets and opinion surveys.

A great way to identify a secular peak, when psychology is at its most optimistic, is to look for a parabolic blow-off in a long-term rate of change (ROC). Charts A6-A12 show secular peaks for six different markets. Note that every instance was followed by a major decline, and/or a multi-year trading range.

In this case, we have used the secular top in the NASDAQ (see Chart A5) as a benchmark where the 18-month ROC topped out at +180%. All six instances followed a multi-year advance. It is important to make this qualification because very high readings in the 18-month ROC have often been witnessed coming off a major low. For instance, the highest reading in the ROC for the S&P was seen in 1934, as the market bounced off its 1932 bottom.

By the same token, it is important to note that not all secular peaks are associated with an ROC parabolic blow-off. The 1990 top in the Japanese market, for instance, did not attract a high reading in the ROC, yet this market certainly reflected an extreme in optimism as witnessed by unbelievable levels of overvaluation.

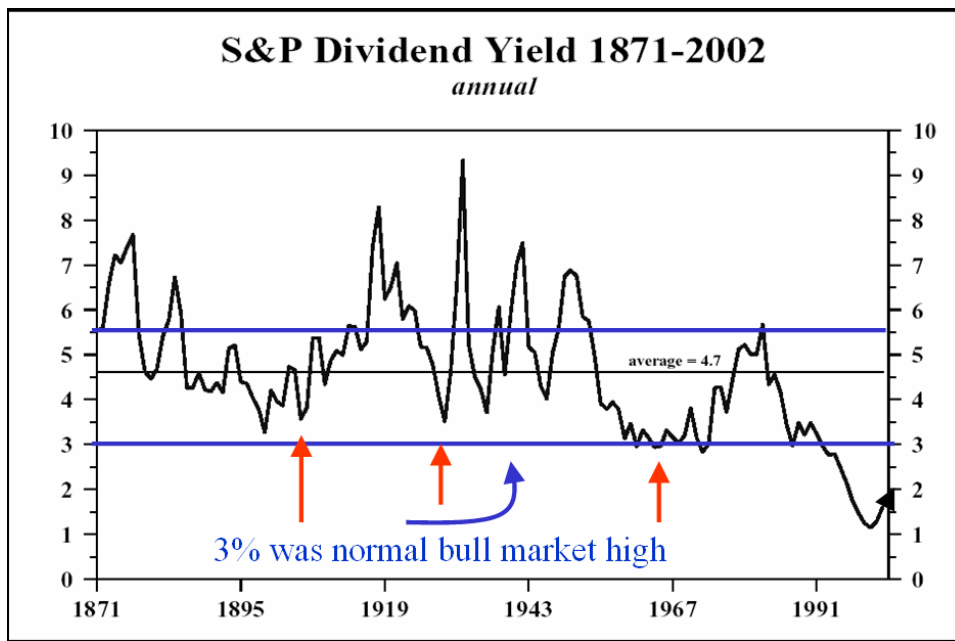


Chart A4

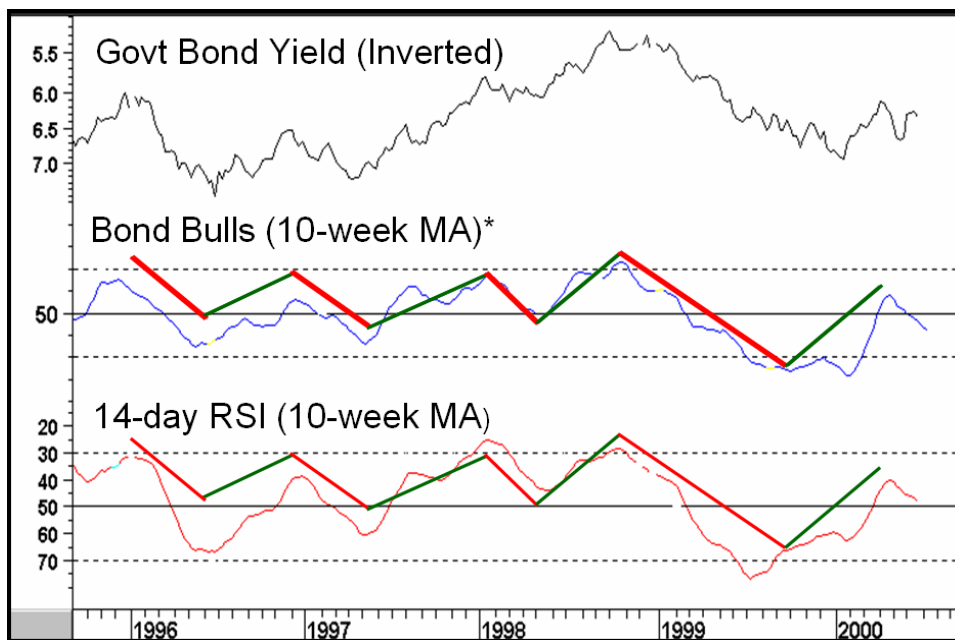


Chart A5

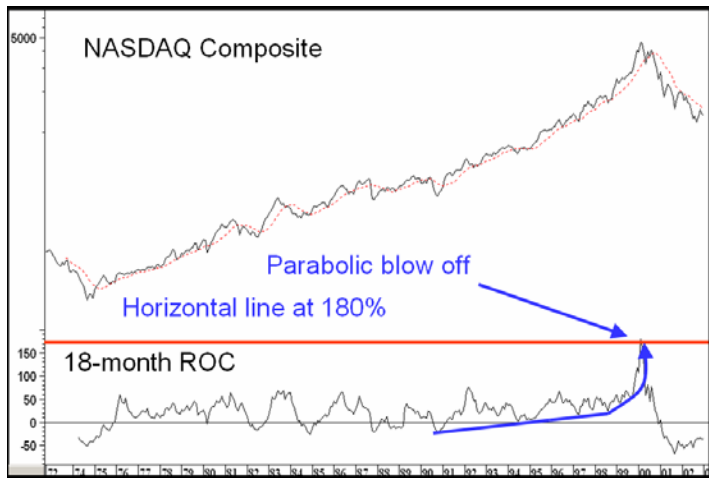


Chart A6

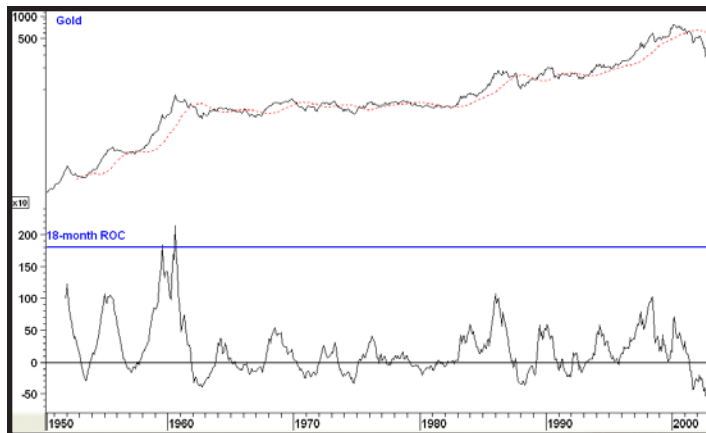


Chart A9 *

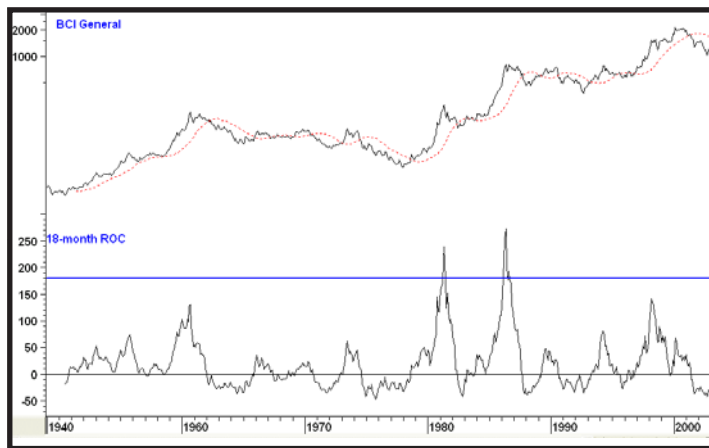


Chart A7 *

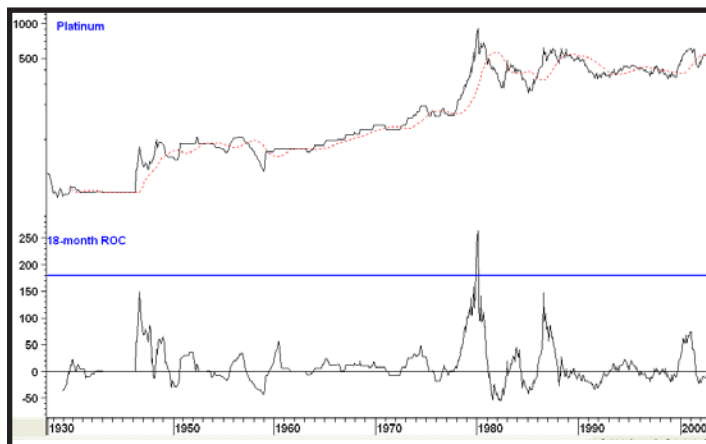


Chart A10 *



Chart A8 *

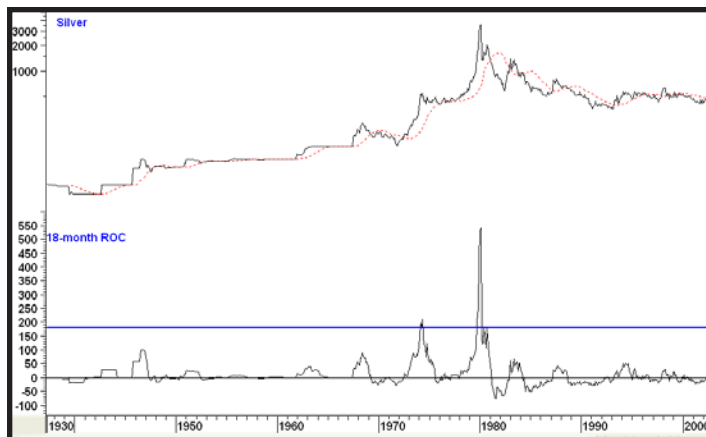


Chart A11 *

** Horizontal line is at 180%*

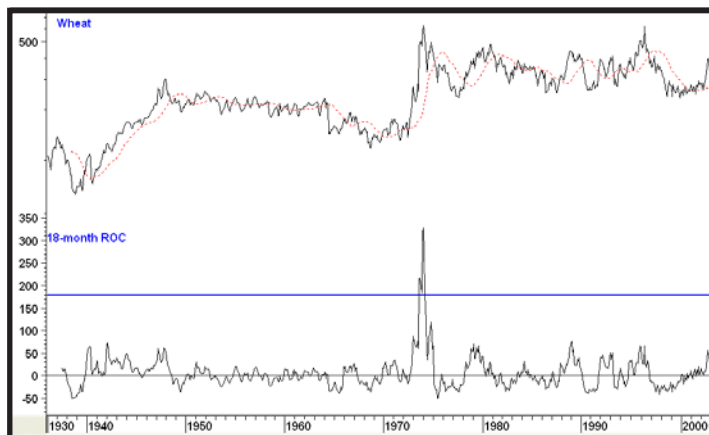


Chart A12 *

The Lesson for the US Stock Market

Secular trends in over and under valuation of equities appear to operate independently from those of commodity prices and bond yields as described by business cycle economists Joseph Schumpeter and Nikolai Kondratieff. Indeed, the corrective periods following the 1902 and 1966 peaks were associated with a secular trend of inflation while the peak of 1929 developed during a deflationary one. The only discernable pattern is that these periods of corrective overvaluation alternate between inflationary and deflationary trends. There are not enough cycles to base a solid conclusion, but if the “alternate” theory works out, this time the current correction should develop under a deflationary environment.

Data from the nineteenth century is quite sketchy and needs to be treated with some caution. The following table suggests that there is an approximate relationship between the time taken for the correction and its severity. Either it takes a long time and the magnitude is muted, or it is over quickly but the decline is sharp. Thus the 1835/42 secular bear market was relatively short but severe, whereas the 1881/96 was fairly lengthy but limited to a 36% decline.

Nineteenth Century Secular Bear Markets

Date	Length (years)	Decline (%)
1835-42	7	75
1853-59	6	60
1869-77	12	45
1881-96	15	36

In conclusion, the corrective period following a secular peak of overvaluation does not have to take the form of a massive decline, but can just as well be spread out over a couple of decades in the form of an extended trading range. Even in this situation, prices on rallies occasionally exceed the secular “peak” itself. Since the NASDAQ has already lost almost 80% of its value, and the S&P 50%, we may well be at the lower end of a multi-year trading range. Indeed, the 3-year 80% NASDAQ decline could well be sufficient to meet the magnitude requirement of the correction. Even so, the pendulum of crowd psychology as reflected in P/E ratios and dividend yields is nowhere near the extremes normally associated with a secular, or even cyclical, turning point. If a trading range is to evolve, we are probably very close to the lower point at the present time. This can only mean further price erosion or a multi-year trading range in which the fundamentals catch up with prices. Whichever way it unfolds, it is apparent that the successful buy and hold philosophy of the preceding secular bull market no longer holds as a more flexible buy and trade strategy is the order of the day. When, after many years, the crowd finally adjusts to this new environment it will then be time to adopt the buy hold approach once again. ■