May 2010

Bear Hunting

Now that the stock market is up over 80% from its March 2009 low, it is time to start asking when this rally could end. Before we get to this question, please allow me the chance to make the case that we are in a short-term up move within the back drop of being in a long-term down-trend.

"The stock market averages 8-10% per year over time" has been repeated mindlessly by thousands of financial advisors. The problem with that statement is that it is only over the very long-term. The dirty secret of the stock market is that it operates in long-term or "secular" cycles in which stocks go from extremely cheap to extremely expensive. During these secular cycles, investors go from extreme despair to extreme optimism and back again. Within these longer cycles, there are counter-trend rallies that are good at tricking investors out of their money. The chart

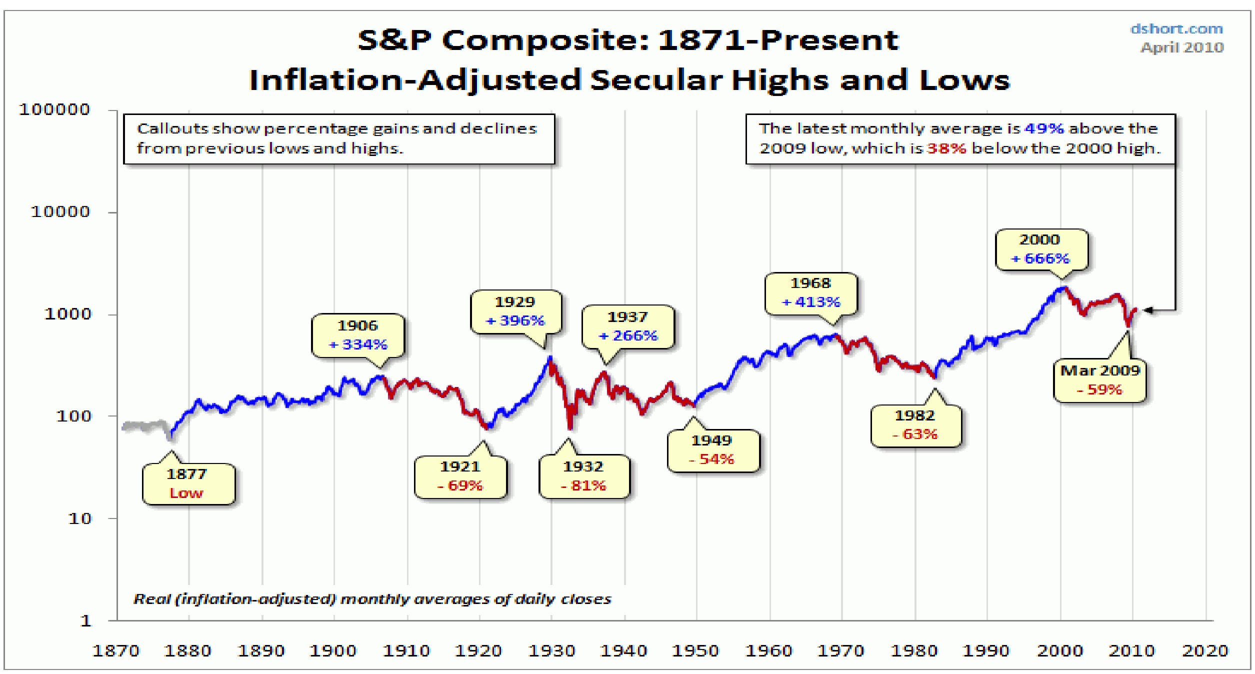
Chart courtesy of Barry Ritholtz, The Big Picture http://www.ritholtz.com/blog/

below shows the Dow Jones Industrial Average from 1900 to 2004. The creator of the chart labels the secular bear markets in red and the secular bull markets in green. As you can see, there are clearly times when "buy and hold" works and times where "buy and hold" turns out to be "buy and hope."

Many investors are painfully aware that since 2000, the S&P 500 is down about 10%. Fortunately, we have ten bad years behind us, unfortunately the last long term bear market was 18 years and the one before that was 17 years. If history repeats itself, there will be 7-8 more flat to down years to frustrate stock investors even further. I expect the stock market to become extremely cheap in 7-8 years (this does not mean the March of 2009 lows will be broken). At this bottom, it is likely that we are in war, have price and capital controls, and many will be making predictions of the "end times." I hope to be there at this bottom pounding the table to "buy and hold" stocks for the next 8-20 year "secular bull market."

I believe that the rally from March of 2009 is just a "cyclical" or short-term bull market rally in the context of the longer term secular bear market that we have been in since 2000. Playing the cyclical bull markets can be profitable, but we have to keep them in context of the bigger picture.

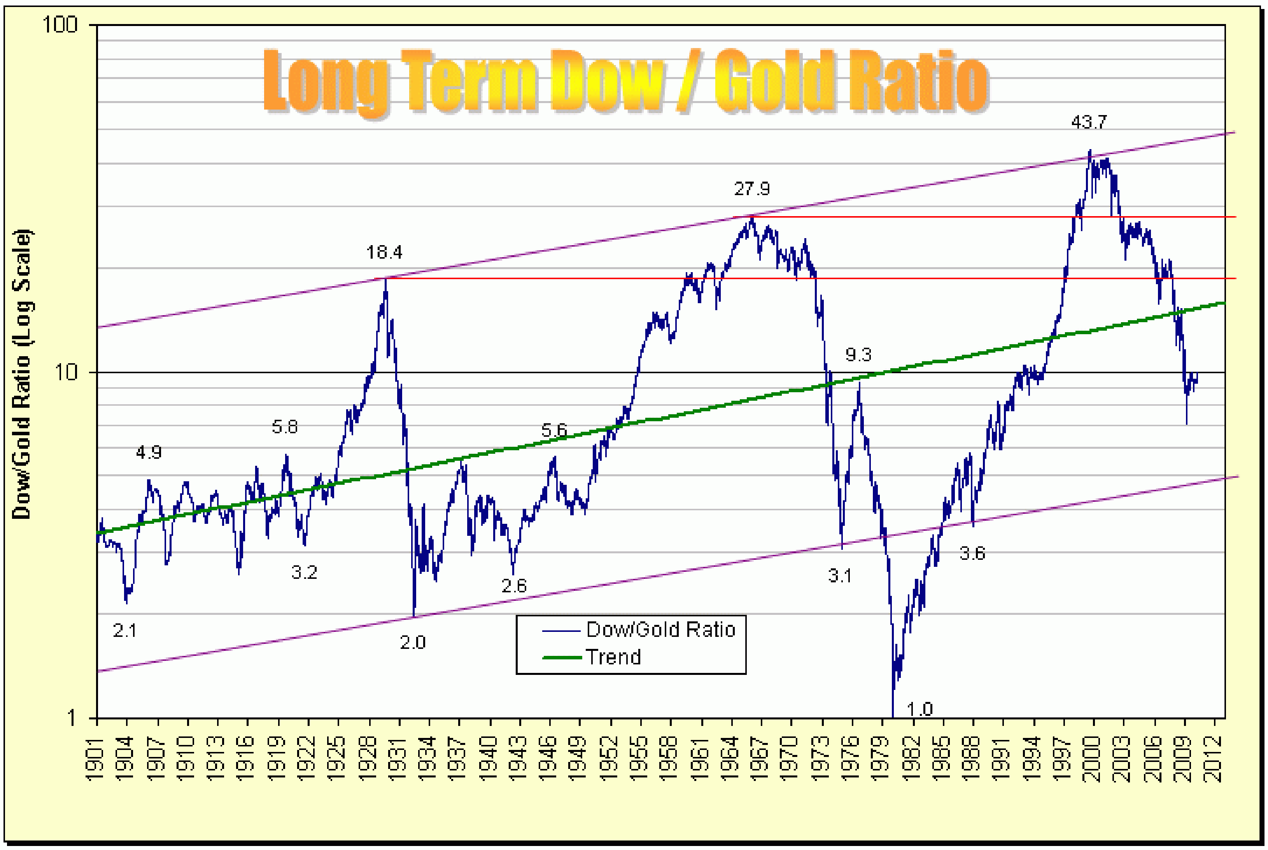
Secular bear markets are even more destructive to your wealth when you take inflation from your returns. As you can see in the chart below, the secular bears look even more devastating. I think it is also very important to note that after inflation, the S&P 500's performance is not nearly as exciting over even a very long term. After all, the only logical way to look at performance is how much more your portfolio can buy you when you actually need the money.



http://dshort.com/charts/SP-Composite-secular-bull-bear-markets.html?SP-Composite-secular-trends

“There is no subtler, no surer means of overturning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose,” said Vladimir Lenin according to John Maynard Keynes.[1]

My last chart to support the claim that we are still in a secular bear market is the Dow/Gold Ratio chart below. This chart shows how many ounces of gold it takes to buy the Dow Jones Industrial Average. Every time the blue line is going up, stocks are out-performing gold. As you can see, during the last secular bull market in stocks, you did not want to own gold (1980 to 2000), but by 2000, U.S. stocks were extremely expensive relative to gold. Gold has since outperformed the Dow by a wide margin. It seems likely to me that the secular bear market in stocks will not be over until



http://home.earthlink.net/~intelligentbear/com-dow-au.htm

the ratio touches the bottom end of the trend channel around 5. That ratio could be Dow 10,000 and gold $2,000 or that could be Dow 1,000 and gold $200 or any other combination. Depending on how insane Bernanke turns out to be, we may even see a 1 to 1 ratio like we did in 1980.

The last piece of evidence of why I believe that we are not in a new “secular” bull Market comes from Gluskin Sheff Chief Economist, David Rosenberg:

[1] http://en.wikiquote.org/wiki/John_Maynard_Keynes

Why this is not the onset of a new secular bull market- Comparisons with August 1982

-P/E multiples were 8x, not 26x.
-Dividend yields were 6%, not sub 2%.
-The stock market was trading at a discount to book, not a 2x premium
-Monetary policy was aimed at reducing money growth and inflation rates, not creating - both as is the case now.
-Fiscal policy was aimed at reducing non-defense spending, not accelerating it.
-Deficits were peaking and coming down, not surging to 10+% relative to GDP.
-Global trade barriers were being torn down; not erected.
-Deregulation back then was in; today it is all about re-regualation and government ownership.
-Union membership was on the way down; today it is back on the rise.
-The dollar was entering a Plaza Accord bull market, not a mercantilist bear market.
-Credit, household balance sheets and participation rates were expanding, not contracting.
-Tax rates, income, capital gains and dividends, were declining then; rising now.

In 1982, Ronald Reagan was President (two consecutive terms as Governor of California), Don Regan was Treasury Secretary (35 years of financial sector experience), Martin Feldstein as the Chief Economic Advisor to President Reagan (the dean of business cycle determination), and Paul Volcker was Fed Chairman (9 years of prior financial sector experience. Compare and contrast to Barrack Obama (Junior Senator from Illinois for three years); Timothy Geithner (21 years experience in the government, three years as a lobbyist); Larry Summers (no private sector experience; 27 years of academia and government) and Ben Bernanke (no private sector experience; 30 years of academia and government).

Which team do you think deserves the higher multiple—the one with actual experience in the real world or the one immersed in academia and government?[2]

[2] http://www.cmgfunds.net/sys/docs/178/CMG%20December%202009%20Update%20%20Time%20to%20Sell%20the%20Rallies.pdf

Where can we expect this Rally to End?

On March 4, 2009 (two days before the stock market low) Steve Leuthold appeared on Bloomberg News stating that "every investor should be considering putting some money into equities.[3]" He advised that investors should be selling his Grizzly Short fund which went up almost 74% in 2008. At the time, his prediction of a minimum target of 1,000 on the S&P 500 by the end of 2009 seemed ludicrous to many.

S&P 500 Bull Markets

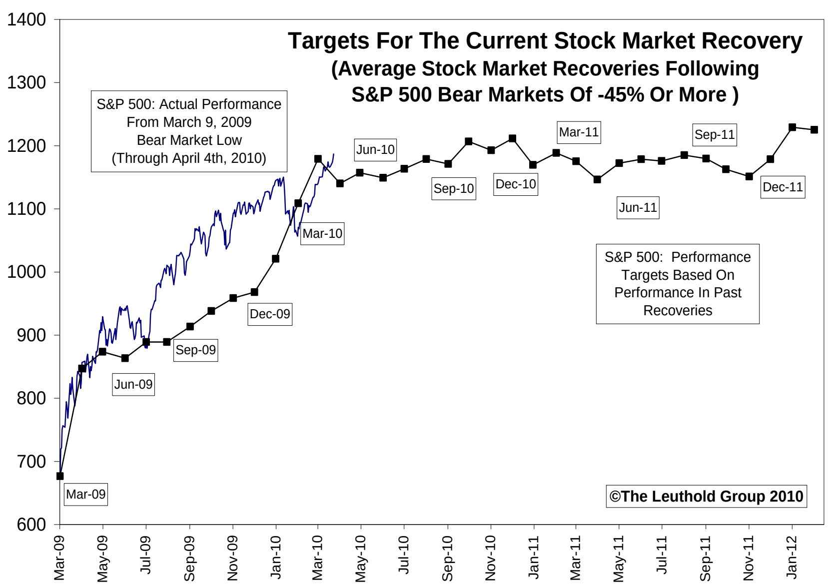
©The Leuthold Group 2010 (1926 to Present)

Stock Market Peaks & Troughs: Date Of Market Trough	Market Trough Level	Market Peak Level		Bear Market Statistics: Date Of Market Peak	Trough To Peak Performance	Duration Of Bull Market
Jul-8-1932	4.41	12.20	1	Jul-18-1933	177%	24.5 Months
Mar-31-1938	8.50	13.79	3	Nov-9-1938	62%	8.5 Months
Apr-28-1942	7.47	19.25	4	May-29-1946	158%	49 Months
Oct-3-1974	62.28	107.83	10	Sep-21-1976	73%	23.5 Months
Oct-9-2002	776.76	1565.15	16	Oct-9-2007	101%	60 Months
				Average	**114%**	**33 Months**
				Median	**101%**	**25 Months**
Mar-9-2009	676.53	???	17	???	76% *	13 Months *

** as of 4/5/10 high*

The chart to the left comes from Leuthold's April "Green Book." It shows bull market performance after the five previous 45% or greater stock market crashes in the S&P 500. Admitedly, this is a small sample size, but it does give us insight to how investors have behaved after crashes.

If the S&P 500 were to peak at the median 101% gain, that would put us at 1360, which is 12% above April 26 levels. The chart below compares the current cyclical bull market to a plotted chart of the average return off the lows of the previous five bull markets that came after a 45% or greater decline. Each cycle is going to be different and there is no assurance that we are going to follow the average of the previous five cycles. This chart does give us a glimpse of when we *could* see the next peek. If we follow averages, the next market top would come right around the November elections.



As you can see, we are currently very close to the average post-crash stock bull market after 13 months.

In December of 2009, Steve Leuthold made a prediction that the market would correct 8-10% in January and then go onto 1350 later in 2010.[4] He was sure to warn that predictions are for show, but when it comes to managing money; he will not reduce stock exposure until his "Major

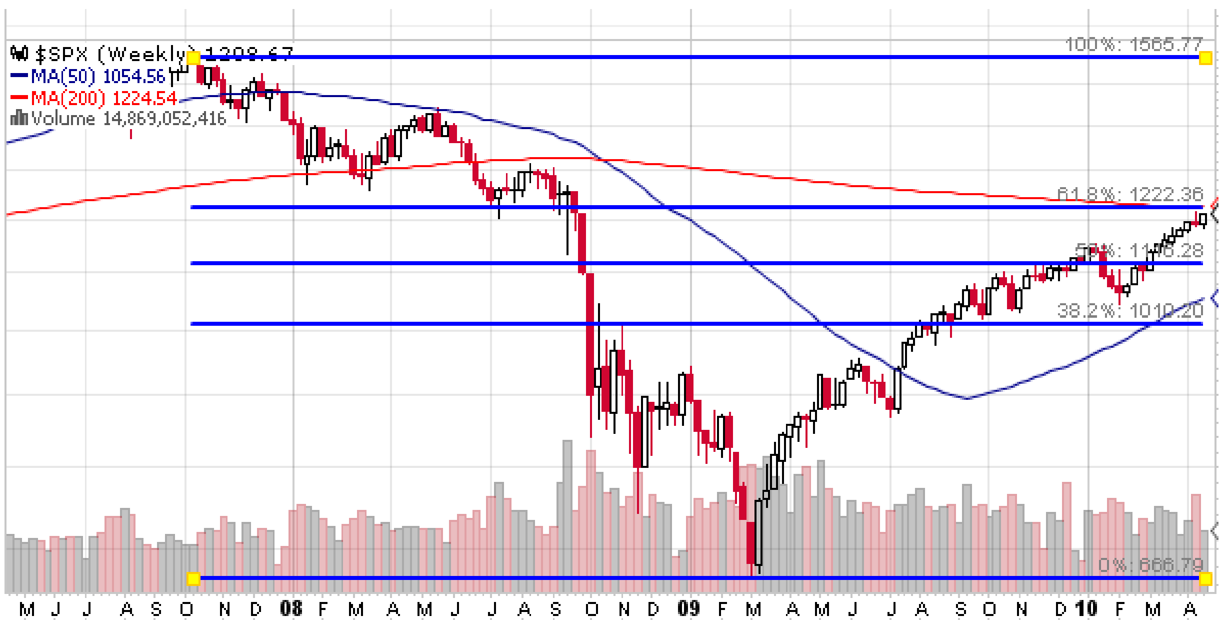
[3] http://www.youtube.com/watch?v=m-NwpcQV010
[4] http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aN7PyxTR2olY

Trend Index" tells him that it is time.

Another popular method for predicting the end of a stock market rally is to use a Fibonocci retracement. Leonardo Fibonacci da Pisa was a mathematician in the 1200s that is known for the Fibonocci Sequence. He was posed the question:

How many pairs of rabbits placed in an enclosed area can be produced in a single year from one pair of rabbits if each pair gives birth to a new pair each month starting with the second month? He arrived at an answer of 144 pairs by creating the following sequence 1, 1, 2, 3, 5, 8, 13, 21, 34…to infinity.[5] After the first few numbers in the sequence, any number divided by the next number in the sequence will give you .618—how amazing? .618 is called the golden ratio and many believe that some of the keys to the universe are locked into this ratio. This ratio can be seen in the torso of a human body/full body length, hurricanes, spiral galaxies, nautilus shells, and the double helix nature of DNA.[6]

The golden ratio also shows up in stock markets and many charting software programs have a "Fibonocci Retracement tool." It is fairly typical for a stock market to retrace or "make up" 38.2%, 50%, or 61.8% of a total correction. Sound a little crazy? Maybe it is, but I can guarantee you that thousands of traders will begin to bet against the S&P 500 once it hits the 1222 level in the chart below.



Courtesy of StockCharts.com

The S&P 500 has gone up about 550 points from its 666 low. I think it is a safe assumption that the bulk of returns are already in for this cycle. Here is my current list of concerns:

- Sovereign debt problems

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[5] Robert Prechter, Jr., *Elliott Wave Principal Key to Market Behavior* (Gainsville, GA: New Classics Library, 2005), 101-103.
[6] Robert Prechter, Jr., *Elliott Wave Principal Key to Market Behavior* (Gainsville, GA: New Classics Library, 2005), 112-119.

- Bankrupt municipalities
- Banks playing "extend and pretend" with their "mark to make believe" accounting
- We need to hire 150,000 people per month just keep up with population growth
- Rising interest rates
- Tensions between N. Korea and S. Korea heating up
- Tensions between Israel and its neighbors
- Tax hikes in 2011
- Extreme bullish sentiment

With a worry list like the above and very strong returns in most markets, I believe the prudent person should start looking at taking selective gains in their portfolio, increasing their stop loss orders, and be open to the idea that we may not be that far away from the next peak in the market.

The stock market could go straight up and exceed its all time high of 1565, but I think the odds of a 20-40% correction before we get there are increasing each week. I am quite happy to begin taking *some* of the gains that I have accumulated over the last year as I stay on the look-out for that next bear.

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