Are We There Yet? Secular Stock Market Cycle Status

By Ed Easterling
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Of course you're getting impatient. When will the stock market shift from secular bear to secular bull—or did it already? The implications are significant. Through much of the 2000s and into the 2010s, individual and institutional investors have weathered quite a storm of low returns and high volatility. *Are we done being battered?* From today, can you reasonably expect above-average secular bull returns like we saw in the 1980s and '90s … or do we face another decade or longer of below-average secular bear returns? [For a 3-minute video explaining the term "secular," click **this link**.]

For many years, analysts and pundits throughout the industry agreed that the new millennium brought with it secular bear conditions. In the past few years, however, opinions have diverged. Notable heavyweights, including Guggenheim Investments, Raymond James, and BofA Merrill Lynch, are on the record that the stock market has entered a long-term secular bull market.

As shown in Figure 1, Guggenheim clearly marks the transition point between the start of the new secular bull market and the end of the secular bear that originally got underway in January 2000. They place that transition point at December 2010, thereby the secular bear lasted eleven years and produced near-zero annualized returns. Then according to Guggenheim, with New Year 2011, a new secular bull market was unleashed.

Now four years and a cumulative +54% later, the Guggenheim chart appears to lead investors to expect a future of above-average secular bull returns. They are somewhat subtle about it; note the implicit investment advice in the upper-left area of the chart: "Investment strategies that work in bull markets may not be effective in flat or bear markets."

> *From today, can you reasonably expect above-average secular bull returns like we saw in the 1980s and '90s … or another decade or more of below-average secular bear returns?*

So true! So apropos this article! In the next five or ten years, will the market surge ahead from the modest uptrend of the past four years, or will the chart action simply blend into the previous eleven-year secular bear? You're probably not reading this article and others like it for their chart designs; you likely want insights about how to position your portfolio. Okay, so what's most likely for the next five or ten years: secular bull or secular bear? On to that in a moment, but first let us observe that Guggenheim is not alone in their outlook.

In Figure 2, Jeffrey Saut at Raymond James marks the start of the new secular bull somewhat later than Guggenheim. Based upon the chart's legend and the notation that the previous secular bear lasted "13+ Years," Saut appears to call the transition in 2013.

Figure 1. Guggenheim Secular Bull Started January 2010

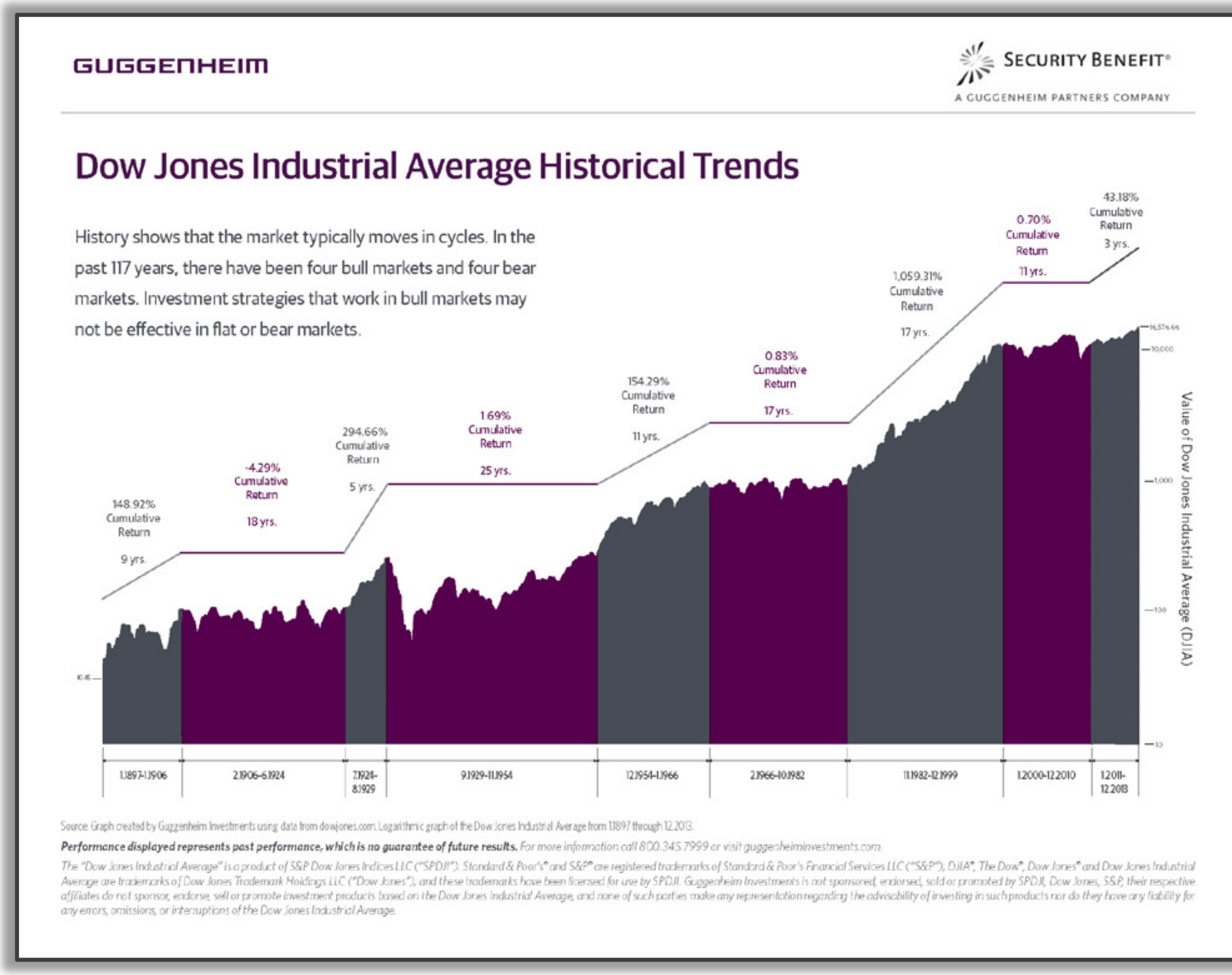
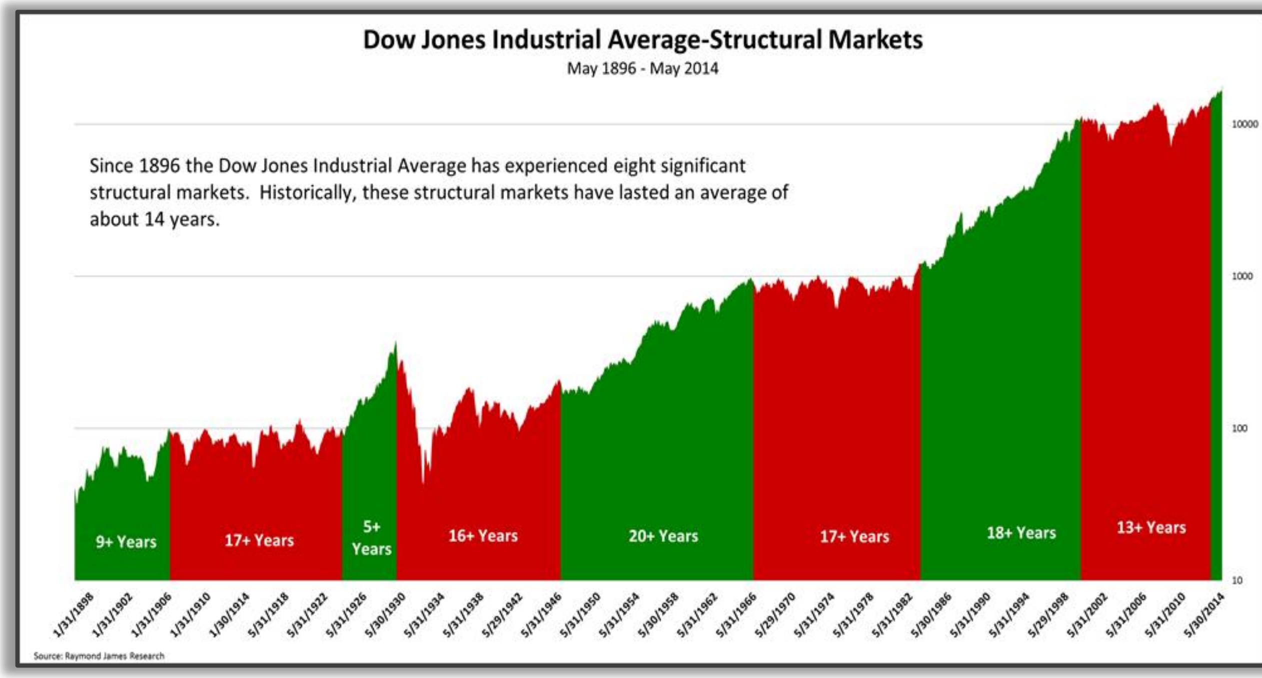


Figure 2. Jeffrey Saut and Raymond James Have the Bull Greening Up in 2013



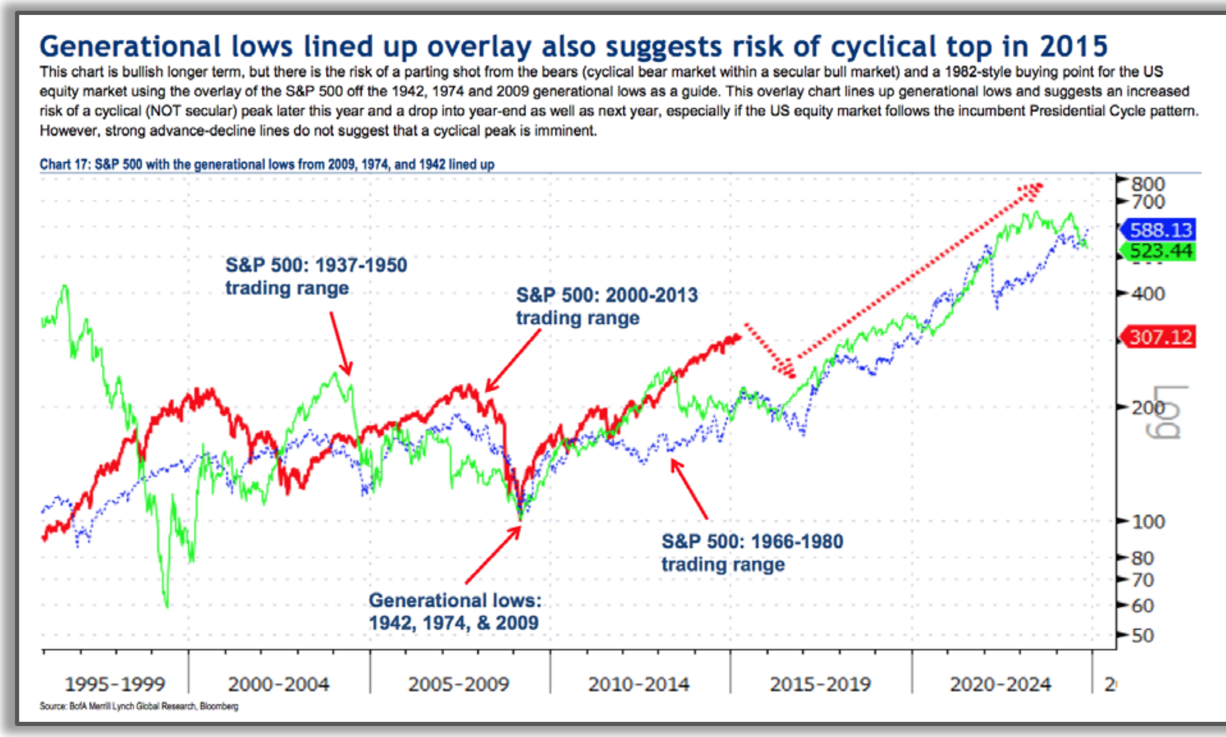
Saut's secular bull green shoots are still developing roots. Nonetheless, his chart does lead the observer to hope that the right margin of the chart will fill with rising green lines. His way of designating secular periods results in an average term of about 14 years—so just over one down and around 12 to go for the new bull!

Last, yet clearly not least, in Figure 3 BofA Merrill Lynch completes the trifecta of secular bull market prognostications. The text in the upper part of the chart reads:

> This chart is bullish longer term, but there is the risk of a parting shot from the bears (cyclical bear market within a secular bull market) and a 1982-style buying point for the US equity market using the overlay of the S&P 500 off the 1942, 1974 and 2009 generational lows as a guide. This overlay chart lines up generational lows and suggests an increased risk of a cyclical (NOT secular) peak later this year and a drop into year-end as well as next year, especially if the US equity market follows the incumbent Presidential Cycle pattern. However, strong advance-decline lines do not suggest that a cyclical peak is imminent.

BofA Merrill says that we're in a secular bull market but that the best opportunities are still on the horizon—the near horizon! 2015 or 2016 will see a pullback during which we should load the boat for a decade during which they predict the stock market will double or triple in value.

Figure 3. BofA Merrill: Secular Bull More Than Doubling Over the Next Ten Years



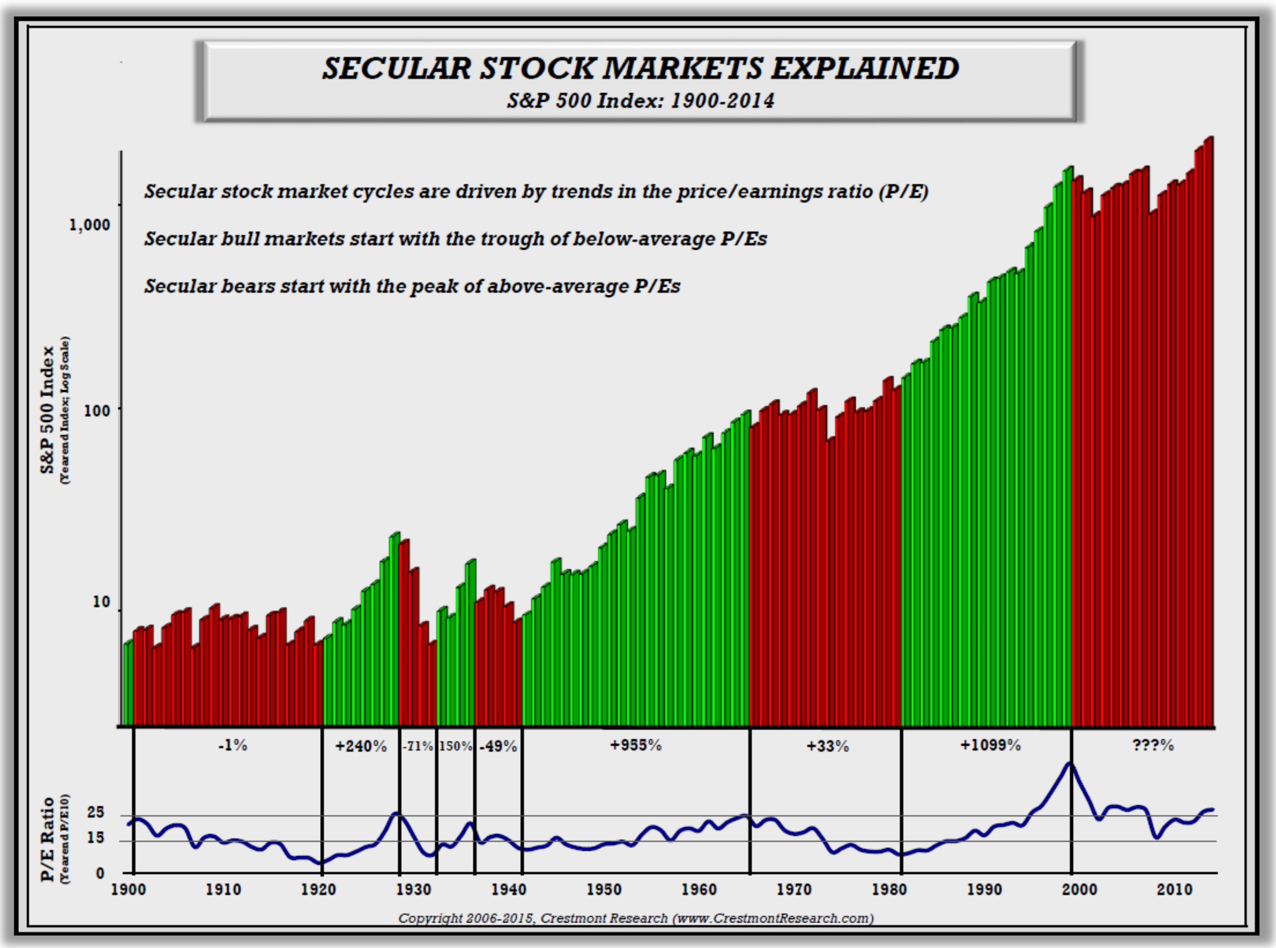
If you are reading this article, you are likely a savvy investor with a few lessons-of-history (and losses-of-experience!) under your belt. You are likely starting to feel a few contrarian hairs tingle on the back of your neck. The upcoming pullback in Figure 3 may even be causing you to see a few flashes of falling knives. So let's explore the alternate view and the implications for investment strategy and portfolios.

ON THE OTHER HAND

Secular stock market cycles are long-term periods of above- and below-average returns. These longer-term periods consist of many shorter-term “cyclical” cycles. During secular bull markets, the cyclical cycles occur along a generally rising path that features higher highs and higher lows. Thus in secular bull markets, cyclical bulls surge and cyclical bears are often somewhat muted.

During secular bear markets, however, the market’s path is generally sideways. As a result, the cyclical bulls and bears tend to be more balanced, with the bulls reversing the declines of bears and bears offsetting the runs of the bulls. The net result of these offsetting cycles is an extended period with disappointing cumulative returns.

Figure 4. Crestmont Research: Secular Bear Remains; No Chance of Secular Bull



In contrast to the secular bull outlook from Guggenheim, Raymond James, and BofA Merrill, Crestmont Research identifies—without hesitation or doubt—the current cycle as the continuation of a secular bear market, as shown in Figure 4. Further, Crestmont has a strong conviction that absent a dramatic crash *and* major deterioration in inflation-rate conditions, the prospect of a secular bull is far away. [For a 5-minute video explaining the “Secular Stock Markets Explained” chart in Figure 4, click **this link**.]

The most significant difference across the four secular charts presented thus far is that the Crestmont chart prominently includes its driver of secular stock market cycles: the price/earnings ratio, which is driven by inflation rate. Note the blue line near the bottom of the chart. The wavy price/earnings ratio (P/E) cycle reflects the level and trend of stock market valuation. Red-bar secular bear markets are driven by a declining trend in the P/E, and green-bar secular bulls are driven by a rising P/E trend. Neither time nor magnitude are relevant.

Secular stock market cycles are not driven by time-dependent phenomena. There is no mystical or explainable term of years over which the market rides waves of bulls and bears. Some chart designers conveniently shift years or combine periods to create such an apparent effect, yet time is not a reliable driver of these periods. (For the most part, none of the previously displayed secular charts resort to this technique.)

Likewise, secular stock market cycles are not driven by magnitude; they don't start and stop at new highs or lows (or relate to certain levels of gain or breakeven). If such a methodology were consistently applied to longer-term secular cycles, the results would be disappointing. That said, the shorter-term cyclical cycles within secular cycles can often be defined well using such a technique. Secular cycles, on the other hand, can be understood only through an examination of the underlying fundamental principles that drive them.

The P/E cycle also is not a phenomenon; it is driven by the effect that the inflation rate has on valuation. As the inflation rate rises, the present value of future earnings falls. Prices (the *P* in *P/E)* decline, with minimal immediate effect on current earnings. Thus, as P falls and E stays nearly the same, the result is a decline in P/E.

Deflation also drives P/E lower. Deflation is the declining trend of future nominal prices. A series of declining future earnings is worth less than stable or rising earnings, thus a trend of the inflation rate into deflation drives P/E lower. As deflation worsens, the value of the market (and thus P/E) declines even further.

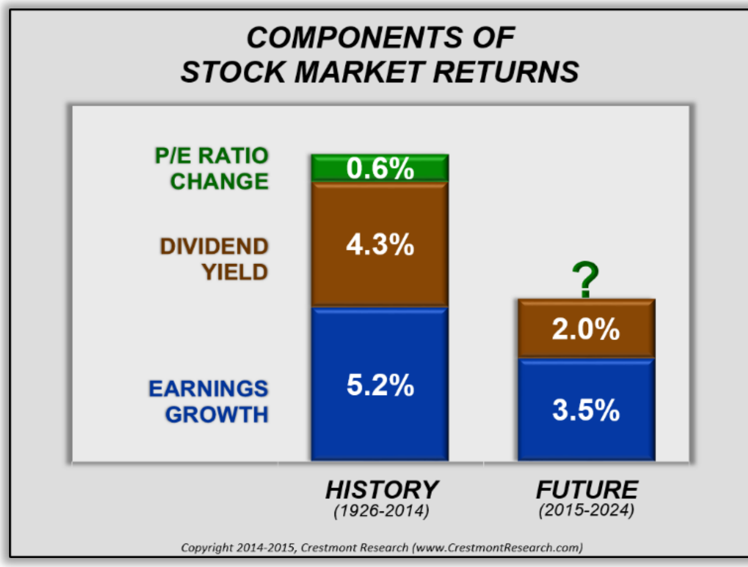
Therefore, a trend in the inflation rate away from low, stable inflation drives P/E lower, while a trend in the inflation rate back toward low, stable inflation drives P/E higher. Thus, as we see in Figure 4, the historical inflation rate cycle drives P/E, which in turn multiplies or offsets the growth in earnings to deliver above- or below-average returns.

COMPONENTS

Let's consider returns from another vantage point. Sometimes it can be revealing to break concepts into their component parts in order to better understand what drives them. For stock market returns, we have a fairly simple machine. There are only three components that combine to provide market returns. Any returns beyond the market return are the result of skill in portfolio selection or management.

As reflected in Figure 5, the three components are earnings growth, dividend yield, and any change in P/E over the holding period. The chart includes values from one of the most recognized series, the one provided by Professor Roger Ibbotson and published annually in the *Ibbotson SBBI Classic Yearbook* by Morningstar. The 2015 values are on pages 156-157. Through 2015 (the series starts in 1926), the cumulative annualized total return is 10.1%. Earnings growth contributed 5.22%; dividend yield added 4.25%; and the change in P/E topped it off with 0.63%.

Figure 5. Components of Stock Market Returns



Those historical values benefit from several factors that are not available today. First, the Ibbotson series starts in 1926, when P/E was 10.2. Over the 89 years since then, P/E has more than doubled. That added gains to the long-term total return. Going forward, however, another doubling of P/E from the currently high level is very unlikely.

Also, the low starting level of P/E in 1926 drove a high dividend yield in the long-term average return. Dividend yield is dividend dollars divided by market price index. For the S&P 500 Index for example, the dividend yield is the total dividends of all 500 companies divided by the market index. When market valuation is relatively low (i.e., low P/E), dividend yield is higher than it is when the market P/E is higher. This is a direct mathematical relationship. The dividend yield of a market that is priced at a P/E of 10 would be twice the yield of a market that is priced at a P/E of 20 (assuming the same dividend dollars). Therefore, since the long-term historical stock market series starts at a P/E of 10.2, it includes a realized dividend yield of 4.25%. Had the starting P/E been at today's level, the dividend yield would have been only about 2.1%. Of course, for today's investors, not only does today's high P/E explain why today's dividend yield is near 2%; it also means that the dividend yield component of future returns will be near 2%.

What is a reasonable expectation for future returns? For this discussion, let's assume that the period is the next decade (2015-2024).

The first component is earnings growth; let's assess its driver. Earnings growth is primarily driven by economic growth. Although profit margins vary across the business cycle, earnings over the long term tend to track sales growth. Measures of the economy, including gross domestic product (GDP), tend to measure the aggregate sales of all companies in the economy. As a result, earnings growth has historically been similar to GDP growth. In reality, earnings growth for large-company indexes like the S&P 500 has been slightly lower than overall economic growth. The economy includes faster-growth small companies and start-ups that tend to outpace the more stable giants.

Over the past 89 years, the inflation rate has averaged 2.93%. Earnings growth is stated in nominal terms, with inflation adding to that component. The current level of inflation is about half of the historical average. If the inflation rate remains relatively low, it would reduce the future nominal growth rate (compared to the historical average) by around 1.5%. In addition, most economists expect real economic growth (and thereby real earnings growth) to slow somewhat into the future. As a result, the estimate for future earnings growth is 3.5% annually, as shown in Figure 5.

Yes, the earnings estimate does assume relatively low inflation. And yes, a higher inflation rate would increase the contribution of earnings growth to total return. However, an increase in the inflation rate would have an even more significant offsetting effect on another component. More on that in a moment.

Dividend yield, as described previously, is highly dependent upon the level of P/E. The relatively high P/E ratio today portends a relatively modest dividend yield for any period starting in 2015. As a result, Figure 5 includes a contribution of 2.0% from the dividend yield component.

The last component is the effect of a change in P/E. An increase in P/E adds to the returns provided by earnings and dividends; a decrease in P/E offsets those contributions to total return.

P/E is driven by the inflation rate. When the inflation rate rises, the effect is an increase in interest rates and a decrease in P/E. When the inflation rate declines into deflation, the result is a decline in P/E. At low, stable inflation, the value of P/E rises to its peak. With today's relatively low, stable inflation rate, a significant trend up or down in the inflation rate will decrease P/E. Therefore, a positive contribution to future total return from a significant increase in P/E is very unlikely.

Returning to the hopes of those who anticipate that higher inflation will add to the component of earnings growth, keep in mind that the adverse effect on the P/E component will more than offset any gains to the earnings component.

As a result, the near-best outlook for the next decade is an annualized total return of approximately 5.5%. Such a decade would essentially leave the current secular bear market suspended in a state of hibernation with no addition or offset from a change in P/E. As a result, at the end of the decade P/E would remain near current levels, and P/E will be no better positioned to double than it is today. For a transition out of secular bear into secular bull, the market must endure the effects of a decline in P/E to levels that will then enable it to double or triple. Such a decline would compromise the "optimistic" outlook of 5.5% annualized returns and instead deliver near zero return.

To illustrate this point, let's review a chart that highlights the course of P/E in secular stock market cycles. Figure 6 reflects the level of P/E for each year of the past four secular bull markets since 1900. The number on the lower axis is the number of years in each cycle. [For a 5-minute video explaining the Secular Market Cycles charts in Figures 6 and 7, click **this link**.]

You'll see that P/E during secular bull markets starts in the low-P/E green zone and treks upward to the higher-P/E red zone. In the most recent secular bull, which ended in a secular bubble, P/E reached the red zone and then doubled again. Regardless, this chart helps viewers to visualize that secular bull markets require a significant increase in P/E.

Figure 6. Secular Bull Market P/E

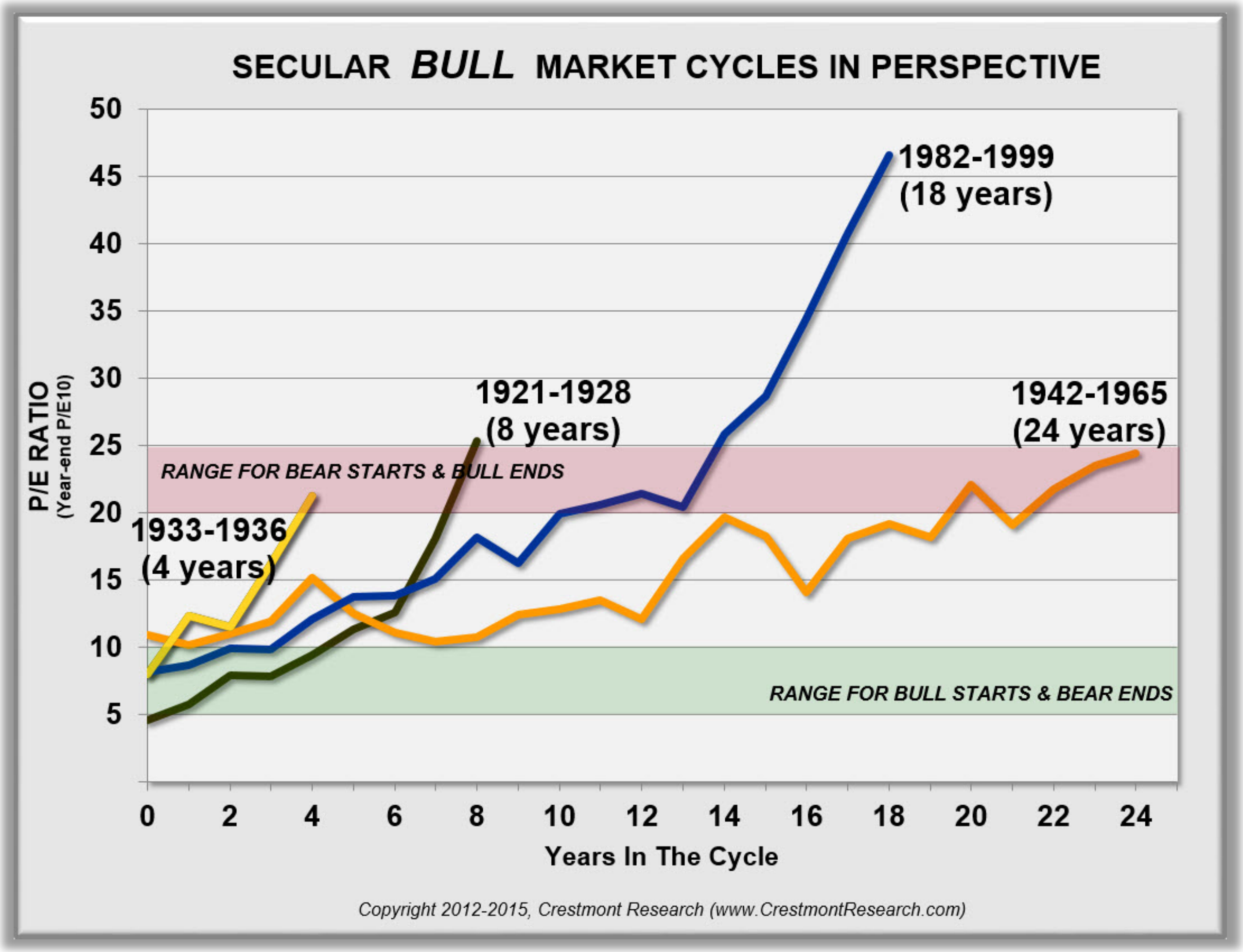


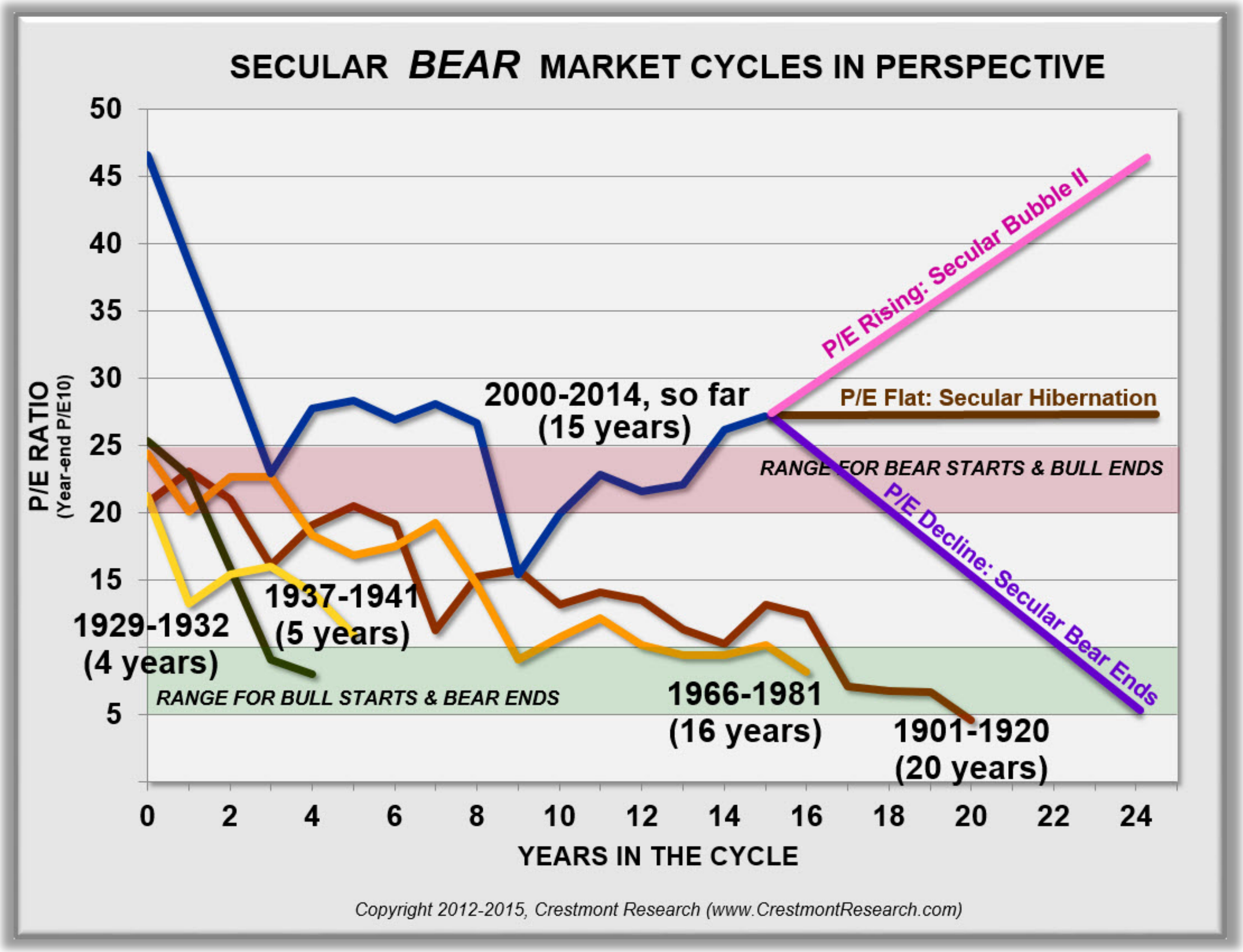
Figure 7 presents P/E during secular bear market periods. Since bears start where bulls end, the starting level for P/E in secular bear markets is generally in the red zone on this chart. The obvious exception is the most recent secular bull, whose dramatic end in a bubble gave our current secular bear quite an extra distance to travel.

Figure 7 includes three extra lines for illustration. They represent the three likely courses for P/E over the next decade. First, the purple line reflects a continuation and conclusion of this secular bear. New secular bull in 2025! The implication for the components analysis is that total return over the decade would be near zero as the decline in P/E offsets earnings growth and dividend yield.

Second, the brown line reflects a secular bear in hibernation. This scenario provides the near 5.5% annualized gain that was illustrated previously in Figure 5.

Third, the pink line reflects a repeat of the late 1990s: a surge of P/E to irrationally exuberant levels. Although this scenario is possible, very few professionals (and not even the most optimistic pundits) would advocate basing your investment portfolio and lifestyle distributions on this outcome. Nonetheless, for the blissfully hopeful, this outlook would deliver annualized total returns just over the long-term average of 10%. It would not repeat the 1980s and '90s secular bull results, because the starting level of P/E is so much higher in 2015 than it was in 1982.

Figure 7. Secular Bear Market P/E



ON THE OTHER HAND AGAIN

There is a third constituency of outlooks for stock market returns over the next decade or so. This group of esteemed market and investment professionals doesn't typically speak in secular-cycle terminology but rather tends to present forecasts for seven- or ten-year returns. Two of the more prominent members of this group are Jeremy Grantham and John Hussman. The current longer-term outlook from each of them indicates near-zero returns from US large-cap stocks.

This outcome can be explained using the previous approach of dissecting the components of stock market returns. Both Grantham and Hussman assume reversion to the mean. That is, their forecasts include the assumption that P/E will be at or near its long-term average at the end of the forecast period. They either don't see the inflation rate as the driver of P/E and/or simply believe that the average value is the most likely level in the future.

If P/E happens to decline to its historical average over the next seven- to ten-year period, the effect of a declining P/E will nearly offset the positive contribution of earnings growth and dividend yield. Therefore, Grantham and Hussman implicitly believe that we're in a secular bear market, even if they don't specifically graph and describe it that way.

CONCLUSION

The current secular bear market has lasted a long time. It's reasonable that investors want to return to a secular bull market environment, but the reality is that the level of stock market valuation (i.e., P/E) is not low enough to provide the lift to returns that drives secular bull markets. As a matter of fact, P/E is at or above the typical starting level for a secular bear market.

The current situation is not the result of P/E hibernation over the past 15 years. *P/E has declined by nearly the same number of points as it has historically in a typical secular bear.* This secular bear, however, started at dramatically higher levels due to the late 1990s bubble. The market's work of the past 15 years has been to deflate the excesses that preceded it.

The passage of time and other factors have led some very smart and respected people to hope for, and then posit, a new secular bull. Unfortunately, the stock market is not positioned to deliver above-average returns over an extended period. We can certainly expect some good years and short-term cyclical runs, but the offsetting loss years will significantly squelch longer-term returns.

Going forward, there are three scenarios. We could repeat the secular bubble of the late 1990s, yet that seems highly unlikely. We could enter an unprecedented era of high, flat P/E. If so, investors need to have a rational expectation for near-5% total nominal returns. Finally, we could see the current secular bear run the rest of its course, with P/E declining to levels that portend a new secular bull. The unavoidable reality is that the latter scenario means either an extended period of near-zero returns or a shorter period of cumulative losses. The impact of a declining P/E is an offset to returns—the longer it takes to happen, the less dramatic the effect.

A secular bear market is not a time to retreat from the market; rather it is a time to position portfolios and expectations for such an environment. The result can be solid investment success; achieving this success just takes a lot more work than when we are enjoying the fruitful conditions of a secular bull.

Ed Easterling is the author of Probable Outcomes: Secular Stock Market Insights *and the award-winning* Unexpected Returns: Understanding Secular Stock Market Cycles*. He is currently president of an investment management and research firm. In addition, he previously served as an adjunct professor and taught the course on alternative investments and hedge funds for MBA students at SMU in Dallas, Texas. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.*