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The Long Equity Cycle – Stock Market Conditions – Part 2

Last week we highlighted why, over the long term, it makes sense for most investors to not be completely void of U.S. equity exposure in their investment portfolios. We demonstrated that more than half of the available return in the S&P 500 index since 1979 was generated ***during the 50 "best" return days. Out of 9,200 trading days, more than half of the market's overall return occurred in ½ of 1 percent of the trading days. With these odds, it is hard to justify being completely void of equity exposure at any time.***

That being said, we also showed the results an investor would have received if they avoided the ***50 "worst" return days. If an investor was lucky enough not to have money invested in stocks during the 50 worst days over that 35+ year period, the annual return that fortunate investor would have received would have been more than 21 percent annually…almost double the return the "buy and hold" investor received.***

Consequently, we hold the view that, to a limited degree, making an attempt to add value to portfolios with slight tactical overweight/underweight decisions regarding U.S. equity exposure has the capability of adding serious positive results to a "buy and hold" strategy.

It is important to note that we are not suggesting a market timing strategy is appropriate when the market timing strategy includes an all-in or all-out concept. I am referring to a disciplined approach to asset allocation – there are times where having a little more or less than normal exposure to the market makes sense.

Over the last 115 years, there have been long stretches of time when stocks have generated much higher-than-normal rates of return and long periods of time when returns have proven less than satisfactory. We call these periods secular bull and bear markets. If we can identify secular bull/bear markets, we have the building blocks with which to make recommendations as to weightings in long-term asset allocation.

The Long Duration Cycle – Secular Bull and Bear Markets Explained

I have written extensively in the past about secular bull and bear markets. Being able to identify if the U.S. equity market is in either a secular bull or bear market is a very worthwhile exercise. It appears to me that the U.S. equity market (this time the Dow Jones Industrial Average) ***is currently experiencing its fourth secular bull market since 1920. During public presentations, and in writing, over the last three years, we have stated such.*** Secular bull and bear markets are major, multi-year affairs in which stock prices, by and large, rise or fall over long periods of time. They begin and end at major reflection points both economically and within investors' attitudes towards risk assumption. Let's take a look at not only the current, but also the past, secular bull and bear markets.

Price Return Secular Bull Markets	Dow Jones Industrial Average Annual
August 1921 – September 1929	***24.9%***
April 1942 – February 1966	***10.5%***
August 1982 – January 2000	***16.8%***
March 2009 – March 2015	***18.0%***

Price Return Secular Bear Markets	Dow Jones Industrial Average Annual
September 1929 – April 1942	***-10.6%***
February 1966 – August 1982	***-1.5%***
January 2000 – March 2009	***-6.2%***

As indicated above***, the first three secular bull markets, which in total occurred over a 50-year period, generated an average annual return of 15.1 percent.*** The secular bear markets which have occurred were over a combined 38-year period of time during which time the DJIA generated ***an average annual return of -5.7 percent***. ***So, while short term market timing can be a fool's errand, the ability to recognize long-duration cycles can have its own major rewards. Additionally, manic trading activity isn't necessary to skew portfolio allocations with either higher or lower-than-normal equity allocations in an attempt to capture more return and to escape a portion of significant downturns.*** le timing of this magnitude is not wise for the investor to partake, it makes sense to allow for variance of asset allocation in an attempt to capture an increased share of the good days and miss some of the pain of the bad days. ***The exercise can be so valuable that some attempt, not at market "timing" per se, a disciplined exercise of exposing a portfolio to a slightly higher level of equity exposure when there is the probability of the good market days occurring vs. the bad market days.***

Characteristics of Secular Bull/Bear Markets

Secular bull/bear markets tend to be long-duration affairs which, after a period of time, are recognizable. Many of these factors are investor's attitudes toward risk, as reflected in overall market volatility and internal trading activity. With factors provided by Ned Davis Research, (NDR), let's compare and contrast some of the differences between historical secular bull/bear markets by listing some typical factors present at both market extremes:

2009 – End of Last Secular Bear	2000 – End of Last Secular Bull
Market washed out	Market experiencing bubble conditions
Stocks Undervalued	Stocks Overvalued
Market trading with high correlation	Market trading with low correlation
Extreme downside trading volume	Narrow leadership
New lows normal	Record highs normal
High levels of selling into weakness and rallies	High levels of buying of breakouts/dips
Extreme mutual fund outflows	Extreme mutual fund inflows
Extreme fear	Overconfidence (are you rich yet?)
Panic and Capitulation	Speculation
Capital preservation a "core" goal	Capital gain creation a "core" goal
Savings rising	Excessive leverage being utilized

So, where does the market currently stand in relation to these various factors? ***I argue that investor sentiment and attitudes towards risk assumption are somewhere between the bookend extremes witnessed in 2000 and 2009.***

Unfortunately, the same can't be said about the current state of the global bond market. ***Notice the similarity of today's bond market and the stock market of 2000. Overvaluation (negative interest rates), low correlation and narrow leadership (sovereign bonds outperforming other segments), record high prices (record-low interest rates), extreme mutual fund inflows (current total inflows into mutual bond-funds is among the highest we have seen in two years), and capital gain creation a "core" goal (again, negative interest rates). We maintain our stance that bonds may not generate historically-normal return patterns going forward. The bond market has been experiencing its long-term secular bull for more than 30 years without a meaningful correction. This too shall end.***

The current secular bull market is experiencing its sixth anniversary this month. How do the "internals" of the current bull market – returns, and trading activity -- look with the current bull as compared to past secular bull markets? ***Let's compare the current bull to previous secular bull markets.*** Data is provided by our friends at Ned Davis Research, (NDR).

	1921	1942	1982	2009
Dow Jones Avg. Annual Return	19.7%	11.7%	17.4%	18.3%
S&P 500 TR/Long Treas. Bond TR		16.0%	4.9%	13.9%
S&P 500 Div. Yield		-8.4%	-10.1%	-12.4%
S&P 500 100-Day Volatility Index		0.5%	0.7%	0.6%
Credit Spread	2.6%	1.1%	2.2%	2.1%
Long Treas. Yield (point change)	-1.9%	0.0%	-3.8%	-1.5%
Industrial Production (annual %)	9.4%	2.2%	4.0%	3.4%

No significant differences jump out. ***The current secular bull market has been trading very much in-line with past secular bulls. So, is the low we saw in stock prices in 2009 the start of a major secular bull market for stocks? Per Timothy Hayes, CMT, Chief Global Investment Strategist at NDR, if the current bull market "walks like a duck, quacks like a duck and flies like a duck, then it is probably a duck."***

We will be back next week with our third part of this commentary: a discussion regarding secular bull markets and cyclical bear markets that tend to occur while the secular bull is charging. We think you may find our thoughts of interest.

We will be back next week.

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P. S. Please feel free to forward this commentary to family, friends, or colleagues. If you would like us to add them to the list, please reply to this e-mail with their e-mail address and we will ask for their permission to be added.