FirstPoint Financial

WEEKLY MARKET THOUGHTS

March 30, 2015

The Long Equity Cycle – Stock Market Conditions – Part 3

Today's commentary is the third and final installment covering our current thoughts about short and longer-term considerations regarding the U.S. equity markets. Our two previous releases outlined the following observations about the U.S. stock market:

- Short-term market timing (all-in or all-out equity market exposure in a portfolio) is extremely hazardous to an investor's well-being
- Long-term bull/bear market cycles (secular trends) matter
- Skewing portfolio exposure to equity markets (slightly higher or lower) due to recognition of secular trends can be rewarding and shouldn't be thrown into the same construct as market timing

Today we will outline the fact that, even during secular bull markets, cyclical (shorter term) bear markets can, and will, occur. Rather severe temporary declines in stock prices have always accompanied secular bull markets. These contra-trend price movements can be classified as cyclical bear markets.

Secular vs. Cyclical Bull/Bear Markets

Along with recognition of the long-term secular trends within major asset classes, wise investors understand market trends can (and will) be interrupted at times, creating counter-secular events. Historically, these interruptions have been meaningful as far as market activity and downside risk to market prices.

How have previous secular bull markets traded ***within their secular trends? Are there periods when the market struggles? Of course. Stock prices – irrespective of secular or cyclical status, don't move in one direction all of the time. Below are cyclical – or shorter term – historical trading patterns of past secular bull markets.*** Data provided by our friends at Ned Davis Research.

Dow Jones Average – Year of Secular Price Lows

	1921	1942	1982	2009
Years 1-6 Price Return Per Annum	19.7%	11.7%	17.4%	18.3%
1st Substantial Cyclical Retracement	-18.6%	-23.2%	-15.6%	-16.8%
Year of First Retracement	Third	Fifth	Second	Second
Next Substantial Retracement	None	-16.3%	-36.1%	???
Year of Second Retracement	None	Seventh	Fifth	???

It is interesting to note that the current secular bull market is unfolding in like fashion (timing and price change) when compared to the previous three secular bull markets. The severity of the first substantial price correction, which occurred in 2011 following the bottom in 2009, was in-line with the secular bull which started in 1982. The magnitude of the 2011 correction was similar in severity and timing to not only the correction in 1984, but also the stock price correction which occurred in 1924.

Is the current secular bull going to follow the script set forth by historical standards? Nobody knows. But if this bull follows the historical script, investors shouldn't be surprised to see a 10 – 20 percent correction in stock prices occur sometime before mid-2016 (Which is the seventh anniversary of the current secular bull market, according to the folks at Ned Davis Research).

Stock prices have risen for quite a long time since the last 10+ percent price correction, which occurred in 2011. Looking at ***data going back to 1928 reveals the following trading trends:***

Average Time Between Substantial Price Corrections

	10+ Percent Corrections	**20 percent Corrections**
Historical Average	102 Trading Days	299 Trading Days
Current Number of Days Since Last Price Contraction	880 Trading Days	1529 Trading Days
Last Occurrence	April 11, 2011	January 6, 2009

As can be seen, we are well over-due (based on historical averages) to experience a 10 – 20 percent contraction in stock prices.

If this correction were to occur at this stage, we'd urge investors to treat it as a potential reason to put additional resources to work within the equity market. Why? As was previously highlighted, the average duration of previous secular bull markets has been 16 years. We are now passing the sixth anniversary of the current secular bull market. This bull market, based on historical standard, is still reasonably young and should have a long way to run prior to ultimate exhaustion.

Portfolio Management Application

After all this data and historical retrospect, what should investors consider? Let's summarize our thoughts from above.

- Market timing over short periods is perilous work – investors shouldn't pull all capital from an equity market as short-term price trends are volatile and tend at times to be rather random.
- Based on historical data, longer term secular "trends" can highlight when the vast majority of positive returns occur.
- Our work shows that the U.S. stock market is experiencing its fourth secular bull market since 1920. By our reckoning, the current secular bull started in 2009.
- Investor sentiment, trading, and equity market action is very similar to previous long-lasting secular bull environments.
- On average, historical secular bull markets have lasted 16 years, with stock prices rising by an average of 15 percent per year over that long period of time.
- Cyclical (shorter term) stock price contractions normally occur within secular bull market uptrends. These price contractions have historically occurred during the second

or third year of the secular bull and again between the fifth and seventh year. These contractions can be very vicious at times, and short-term in nature (think of 1987 when stock prices declined by more than 30 percent in less than 90 days).

- Based solely on the calendar, the U.S. stock market is well overdue for a price correction which may measure between 10 and 20 percent. It has been 1,515 trading days since the last 20+ percent correction in stock prices whereas, historically, the U.S. market has shown this type of correction every 299 trading days.

As can be seen from the above, we have conflicting statements. We urge investors to own U.S. equities because of our perceived secular bull phase and the fact that being out of the market is a loser's game. On the other hand, we wouldn't be surprised to see a 10 – 20 percent price correction in stocks sometime in the not-too-distant future. We obviously are not aware ***when the 10 – 20 percent price correction will occur, but we are confident it will occur.***

Just for Fun

We have expressed our view in our just-completed trilogy that the U.S. stock market is experiencing its fourth secular bull market since 1920. Below are some quotes from folks much brighter than I regarding investing in the stock market:

"*Invest at the point of maximum pessimism."*

John Templeton

"If you have trouble imaging a 20 percent loss in the stock market, you shouldn't be in stocks."
Jack Bogle

"Look at market fluctuations as your friend rather than your enemy. Profit from folly rather than participate in it."

Warren Buffett

"Psychology is probably the most important factor in the market – and one that is least understood."
David Dreman

Many of you know, or have heard of, Warren Buffett. The other three gentlemen listed above, along with Mr. Buffett, are considered among the "Market Royalty" in the United States over the last century. Wise words from all.

We will be back next week.

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