Nightmare On Wall Street:
This Secular Bear Has Only Just Begun

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Secular bull markets are great parties. Investors arrive from secular *bears* really wanting to take the edge off. As the bull proceeds, above-average returns become intoxicating. By the time it is over, the past decade or two has delivered bountiful returns.

The stock market is finally fairly valued for conditions of low inflation and low interest rates.

In contrast, secular bears seem like hangovers. They are awakenings that strip away the intoxication, leaving a sobering need for an understanding of what has happened.

Conventional wisdom explains these periods as irrational or coincidental periods. In reality, secular bulls and bears are periods driven by longer-term trends in the inflation rate. A trend away from low inflation, whether to high inflation or deflation, drives the value of the market lower. That leaves investors with below-average returns. The return trip—when the inflation rate trends toward low inflation—drives the value of the market higher. That provides investors with above-average returns.

Then there was the "party" in the late 1990s! Intoxication!! Can you imagine a party so extreme that you end the next day feeling just as groggy as when you first woke up? A long, long day of frustration and misery? That day was the past decade. In stock market terms, it has been twelve years of pain that just now brings investors to the *starting line*.

Wake-up…this must be a nightmare.

Oh no, it's not!!!

This is a moment of consternation—an eerie tension between hope and fear. You find yourself saying, "*It's not fair… It doesn't seem right… Secular bear markets average eleven years, don't they? Isn't this one supposed to be over by now? Some pundits are saying there might be just a few more years left in this nasty old bear… What do you mean this secular bear has only just begun?*" We'll get to that in a moment; but for now, please step back from the edge.

Even if a big bull is not around the corner, there's plenty of opportunity. In fact, it's conditions like these that provide the greatest potential for astute investors. First, they

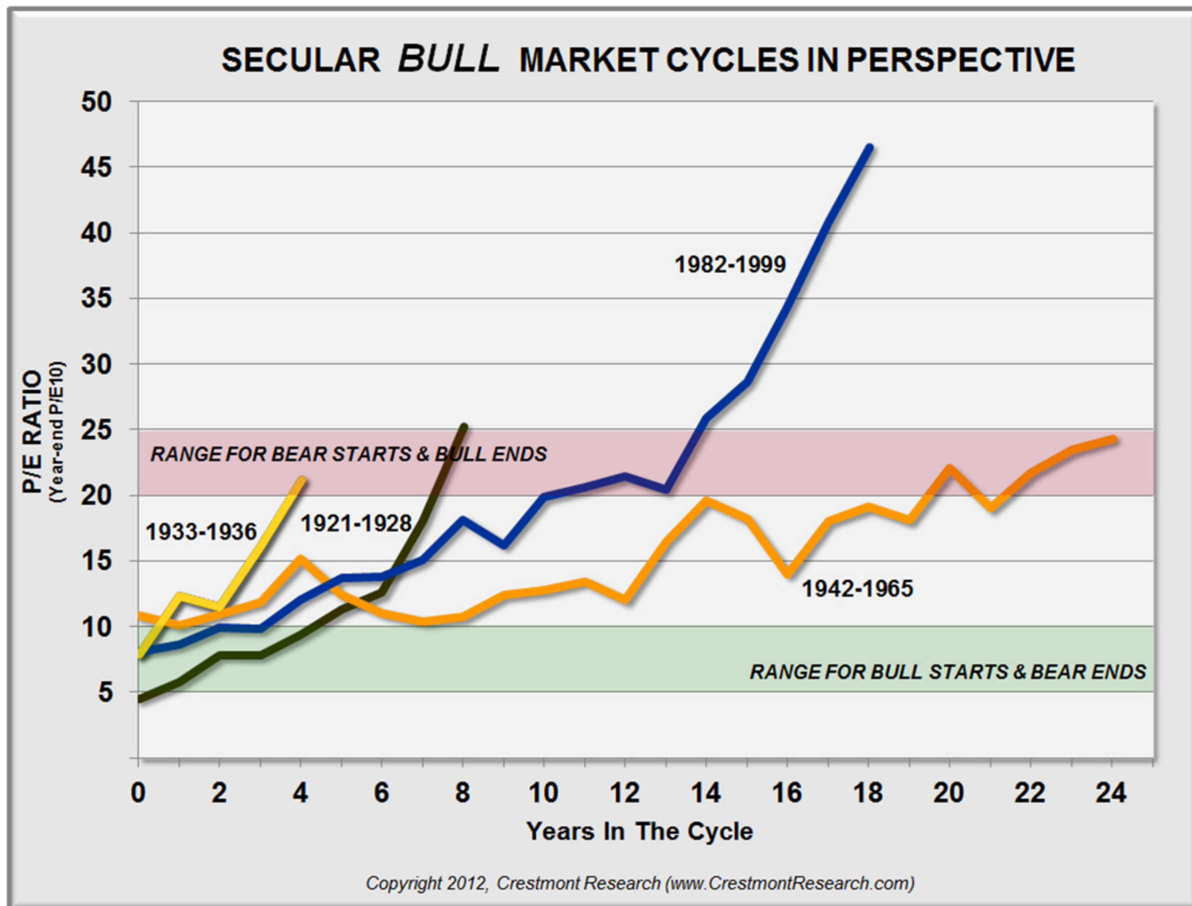
must understand the environment. Then, investors can use that knowledge to their advantage. This discussion is about the first part—understanding. The upcoming charts will explain why we are actually early in the current secular bear and how we got here. There are many other resources for the second part—what to do about it.

SECULAR CYLES IN PERSPECTIVE

Let's start with a look at secular bull markets over the past century. Figure 1 presents all four secular bulls since 1900. Each line represents the price/earnings ratio (P/E) annually over the life of the four secular bulls. The level of P/E is displayed on the vertical axis. Time, in years, is displayed on the horizontal axis.

To reduce the distortions to P/E caused by the earnings cycle, earnings (E) have been normalized using the approach popularized by Robert Shiller at Yale. The index for the numerator (P) is the year-end value for the S&P 500. Therefore, the P/E displayed on the chart is the year-end Shiller P/E (i.e., Year-end P/E10).

Figure 1. Secular Bull Markets



First, note that secular bulls start when P/E is low and end when P/E is high. The low points for all secular bulls have been quite similar. In the chart, the low range is designated with green shading. The high point for all secular bulls had also been fairly similar, until the late 1990s. It is as though the 1980s/1990s secular bull ran its course

through the mid-1990s, then the *party* started and P/E more than doubled again. The already high P/E ascended to the stratosphere. Pundits often compare the late 1990s to 1929. Yes, the valuation of the market (as measured by P/E) was fairly high in 1929. But 1999 is in a league of its own.

As the new millennium opened, the bubble stopped expanding—but it did not pop. An immediate decline of fifty percent would have been required to correct the excesses and to reach a typical secular bear start. Instead, the stock market see-sawed for about a decade. With each decline, it bounced back. As the underlying economy and baseline earnings level grew, the market slowly whittled its P/E back to levels associated with typical secular bull ends and secular bear starts. So it has taken more than a decade to wear away the effects of the late 1990s extremes.

BEAR!

Who says that markets are not considerate? A sudden decline in 2000 would have been a cruel polar bear plunge. Instead, the market tip-toed lower, allowing time for investors to adjust. Some investors have known for over a decade that we are in a secular bear market. Many of them, however, may not have realized just how elevated P/E was when this secular bear began.

Figure 2. Secular Bear Markets

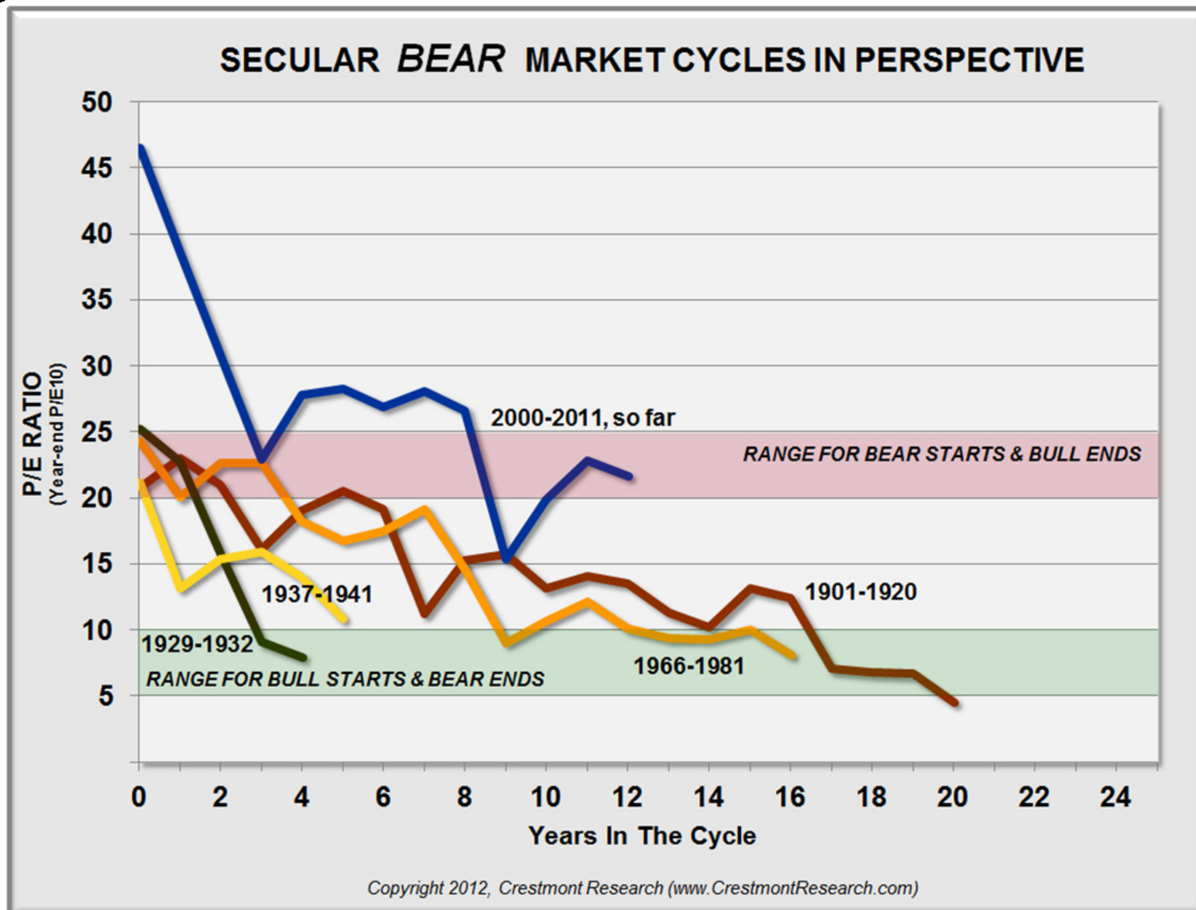


Figure 2 shows just how far we had to go. P/E is on the left axis; time is across the lower axis. The chart presents all of the secular bear markets from the past century. The format is similar to that in Figure 1.

Pause for a moment to reflect upon Figure 2. Contrast it back and forth with Figure 1. Every secular bear cycle prior to our current one followed a secular bull that ended with P/E in or near the red zone. That set the starting point for every adjacent secular bear. But this time, the super secular bull of the late 1990s ended nearly twice as high—it was a major bubble. Therefore, it is realistic to expect that our current secular bear might last a lot longer or be twice as gnarly as past secular bears.

Because the Fed and other factors have kept the economy in a state of relatively low inflation, the current secular bear has ground its way back to the reality of the red zone.

What goes up, must come down. Figure 2 is noteworthy for highlighting the lofty start of the current secular bear. Now after twelve years, the market P/E is down, but only into the red zone. That level, however, is not overvalued. It was overvalued in 2000 and at many points over the past decade. There were not plausible economic and financial conditions to justify P/E near 30, 40, and more.

Now, finally, the stock market is fairly-valued for conditions of low inflation and low interest rates (assuming average long-term economic growth in the future). But what about the future? If inflation remains low and stable indefinitely, then this secular bear will remain in hibernation until the inflation rate runs away in either direction.

A period of hibernation, however, does not cage the bear and allow a bull to roam. Rather, it means that investors will receive returns consistent with relatively high starting valuations—nominal total returns for the stock market of around 5%-6%. Hibernation avoids the declining P/E of a secular bear. It is the decline in P/E that causes secular bears to deliver near zero return.

Hibernation also means that there is almost no chance of better returns. Average and above-average returns require a significant increase in P/E. From the red zone, higher P/E requires an irrational bubble. That is never a prudent assumption for a financial plan.

HOW & WHY

The economy experiences periods of rising inflation, disinflation (i.e., declining inflation), deflation (i.e., negative inflation), reflation (i.e., increasing inflation inside of deflation), and price stability (i.e., low, stable inflation). The periods run in a natural sequence around the starting point of price stability.

To illustrate, the cycle starts with low inflation. Then, due to excess money supply growth or other factors, the inflation rate rises. At some point, economic policies or factors reverse the trend, thereby starting a period of disinflation (i.e., declining inflation). Once back at price stability, the trend can either hold in a state of low inflation or it can move upward or downward across another cycle.

The P/E for the stock market is driven by the trend in and level of the inflation rate. As a result, there is a cycle for P/E based upon the inflation-rate cycle. High inflation and deflation drive P/E lower. Price stability drives P/E higher.

The P/E cycle creates secular bull and secular bear markets. Some secular periods have been long, yet others have been relatively short. Time does not drive secular periods. Rather, the inflation-rate cycle determines whether they will be relatively quick or quite extended. Inflation-rate trends can last a few years or they can extend for decades.

Secular bull markets transition into secular bears, which are followed by secular bulls. Neither secular bulls nor secular bears are isolated periods. Instead, they necessarily precede and follow each other. This is why they are designated as cycles rather than simply as periods.

They are called secular because they have a common characteristic and driver that extends over an era. The term *secular* is derived from a Latin word that means an era, age, or extended period. Actually, an original Latin variation of the word has been closer to hand than most people realize.

On the back of the American one-dollar bill is the Great Seal of the United States. One part of the seal is the circle on the left-hand side bearing a pyramid topped with an eye. Look closely under the pyramid: there is a banner with the phrase “novus ordo seclorum.”

In 1782, Charles Thomson, a Founding Father of the United States, and secretary of the Continental Congress, worked as the principal designer of the Great Seal. There is extensive symbolism included in the seal. When Thomson proposed the seal to Congress, he described the meaning of *novus ordo seclorum* as “the beginning of the new American Era.”

When the word *secular* is used to describe stock market cycles, it expresses that the cycle is an extended period with something in common throughout. Secular bull markets are extended periods that cumulatively deliver above-average returns. These periods are driven by generally rising multiples of valuation as measured by the price/earnings ratio (P/E). Secular bear markets are the opposite: extended periods with cumulative below-average returns driven by a generally declining P/E for the market. Thus the secular aspect of these periods relates to the generally rising or falling trend in P/E over an extended period of time.

THE FUTURE: DECADES

If history is a guide, the inflation rate will at some point trend away from the present price stability. The result will be a significant declining trend in P/E. If this occurs over a few years, the market losses will be dramatic.

More likely, it will take a decade or longer. That will enable the underlying economy and baseline earnings to grow, thereby offsetting the decline in P/E. As we have seen from history, that means another decade or longer of near-zero returns.

When the adverse inflation-rate trend reaches its nadir, we will mark the end of this secular bear and the start of the next secular bull. As the economy or the Fed reverses the adverse inflation-rate trend back toward price stability, P/E will trough at its lows and begin the long climb that drives secular bull markets.

Be careful not to let hope for the next secular bull mask the reality of the current secular bear.

These processes take many years. Be careful not to let hope for the next secular bull mask the reality of the current secular bear. Many more years of vigilant investing will be required for portfolio success. As Robert Frost so aptly wrote: "*The woods are lovely, dark, and deep, / But I have promises to keep, / And miles to go before I sleep, / And miles to go before I sleep.*"

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 President of an investment management and research firm, and a Senior Fellow with the Alternative Investment Center at SMU's Cox School of Business, where he previously served on the adjunct faculty and taught the course on alternative investments and hedge funds for MBA students. Mr. Easterling publishes provocative research and graphical analyses on the financial markets at www.CrestmontResearch.com.*