absolute return partners
newsletter

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April and May proved very challenging months for both equity and bond markets. In fact, April turned out be the first month in several years, where virtually every single asset class deteriorated in value. In this month's issue, we revisit an old theme – the outlook for equity markets – and we argue why there is more trouble ahead. We suggest that we are trapped in a secular bear market, which began in earnest in the spring of 2000.

Four Reasons to be Cautious

Traditionalists define a bear market as a period during which equities fall in value by more than 20%. Market observers usually distinguish between cyclical and secular bear markets (likewise with bull markets). A cyclical bear market is relatively short in nature (anywhere from several months to a couple of years), whereas secular bear markets are longer lasting (13-14 years on average).

In a secular bear market, each rally fails to reach prices of the previous high, so the market gradually moves lower. In his inspiring new book[1], John Mauldin offers a slightly different definition. He defines a secular bear market as a market of falling price-earnings ratios. Never mind the subtle differences in definition. The net result is the same. It is hard to make money.

Contrary to what most people believe, equity prices do not just drop in value during secular bear markets. It is perfectly normal to go through several cyclical bull and bear market cycles within a single secular bear market. In fact, equity prices rise, on average, every second year during a secular bear market. We believe 2003 was one of those cyclical bull markets, embedded in a secular bear market.

Furthermore, and again contrary to perceived wisdom, investors do not usually lose large sums of money during secular bear markets. The average return on U.S. stocks (including dividends) in these markets since 1802 has been 0.3% (see table 1a below) - not the end of the world but not particularly inspiring either.

The main problem with secular bear markets lies in the psychological effect it has on investors. With markets moving sideways for years, patience ultimately runs out, and those who do not have to own equities, throw in the towel.

Table 1a & 1b - Secular Bear and Bull Market Cycles[2]:

Secular Bear Markets		
Period	**Number of Years**	**Real Return per Annum**
1802-1815	13	2.80%
1835-1843	8	-1.10%
1853-1861	8	-2.80%
1881-1896	15	3.70%
1906-1921	15	-1.90%
1929-1949	20	1.20%
1966-1982	16	-1.50%
Overall	**95**	**0.30%**

Secular Bull Markets		
Period	**Number of Years**	**Real Return per Annum**
1815-1835	20	9.60%
1843-1853	10	12.50%
1861-1881	20	11.50%
1896-1906	10	11.50%
1921-1929	8	24.80%
1949-1966	17	14.10%
1982-2000	18	14.80%
Overall	**103**	**13.20%**

It is, figuratively speaking, at the point of the last investor cashing in their remaining chips that the secular bear market will reach the end of its journey, and a new secular bull market can begin.

So how expensive are equities at the moment? Unfortunately, there is no simple answer. Among other things, it depends on whether you include extraordinary write-offs and the cost of issuing options (a proposed new accounting rule which is likely to come into effect in the U.S. from 2006).

P/E ratios are also impacted by the level of interest rates. Generally speaking, the lower interest rates

[1] "*Bull's Eye Investing*", which has served as a source of inspiration for this article. You can learn more about John Mauldin and his work on www.frontlinethoughts.com.

[2] Source: M. Alexander, "*Stock Cycles: Why Stocks Won't Beat Money Markets over the Next Twenty Years*". Based on S&P 500 data.

are, the more investors are willing to pay for equities.

In a recent report[3], analysts at Goldman Sachs argue that the global "fair" P/E level, based on a current 10-year bond yield average of 3.8%, is 15.8 times. As global equity markets currently trade at about 16 times earnings on average (according to Goldman Sachs), they argue that equity markets are just about fairly valued.

We have numerous problems with this approach, though. For one, including Japan distorts the data because Japanese bond yields are so low. If one were to include only the U.S., Euroland and the U.K. in the analysis, a vastly different picture would emerge. The average 10-year bond yield is now close to 4.6%. The "fair" P/E level is about 13.5 times and equity markets suddenly look overvalued.

U.S. equities, trading at just over 19 times 2004 estimated earnings versus a long-term average of about 15 times, look particularly expensive.

German equities trade closer to their long-term average P/E at just over 15 times 2004 earnings. However, analysts are forecasting a significant improvement in profitability for German companies from 2003 to 2004. If expectations are not met, German equities will suddenly start to look expensive.

In the UK, shares are also somewhat ahead of their long-term averages at 18.5 times earnings. Again, a major improvement in profitability is required to meet estimates. On last year's earnings, the P/E is almost 25.

Table 2 – P/E Ratios for Selected Markets[4]:

Market	2003	2004
USA	23.0	19.1
Germany	26.4	15.2
UK	24.9	18.5

We hope you get the point. Discussing P/E levels is a can of worms, because there is no simple answer. For the purpose of the analysis below, suffice to say that P/E levels at the moment are above average. In some markets, they are actually way above average.

Let's instead go back to where we began – suggesting that we are in a secular bear market. There are essentially four reasons why we believe so.

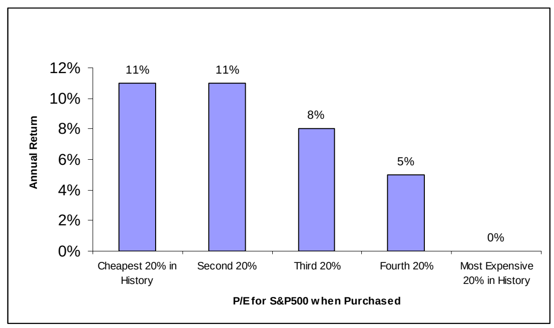
Reason # 1:

High P/E ratios usually lead to low returns. In 2000, Professor Robert Shiller of Yale University wrote a book called "Irrational Exuberance". In this book he demonstrates a statistically significant link between P/E ratios and subsequent long-term returns.

From his analysis we can conclude that when P/E ratios are around 20 or higher (as is the case now in the U.S.), investors should expect low single digit returns at best. There is not a single case in history where the ten-year return has exceeded 5%. There are several 10-year periods with negative returns.

Jeremy Grantham of GMO Advisors has come to virtually the same conclusion in a similar study from 2002. He divided the market into quintiles based on P/E ratios. As table 3 below demonstrates, he found that the real return on U.S. equities in the ten years following those 20% of years with the highest P/E levels has been 0%. Our readers should not be surprised to learn that this is the very quintile we find ourselves in at present.

Table 3 – 10-Year Real Returns on U.S. Equities



Reason # 2:

Rapidly rising oil prices often lead to falling equity markets. Although the relationship is far from linear, there is clearly an inverse relationship between oil prices and equity market performance.

This link was reviewed in great detail in our April newsletter, so we shall not dwell too much on the subject. However, let's quickly recap what we concluded in April.

Rapidly rising oil prices act as a shock to financial markets. Obviously, the degree to which equity markets react negatively is a function of speed and magnitude. In his recent book "*The Oil Factor*", Stephen Leeb argues that equity investors get by far the best returns when year-on-year increases in oil prices are below 20%. At present, oil prices are more than 40% higher than at the same time last year.

Stephen Leeb finds that some of the largest drops in equity prices over the last 3 decades have been preceded by year-on-year increases in oil prices of 80% or more. An increase of this magnitude would imply an oil price of about $50 which is not on the cards for the foreseeable future. Did we hear someone say *"famous last words"*?

[3] *"Portfolio Strategy – Bear Repair"*, 26th April 2004
[4] Source: S&P, Bloomberg, 25/05/2004.

Imagine the following scenario: You sell the S&P500 whenever the year-on-year rise in oil prices is 80% or greater. You get back into stocks, whenever the year-on-year change falls to 20% or less. Since 1974, there have been five such sell signals and five buy signals. The total return for the S&P500 over this period is 3400%. The total return over the same period, assuming you only invested in equities while the signal was negative, was a miserable -25%. However, had you only invested in equities while the signal was positive, you would be up by 6900% by now. Point made.

Before leaving the subject of oil, please allow us to remind you of one other relationship, which is exceedingly important in today's environment. Professor Andrew Oswald at Warwick University has found a strong link between oil prices and credit spreads. In other words, when oil prices rise, credit spreads widen (and visa versa). Many investors have been chasing higher yielding bonds in the corporate and emerging markets segments. If oil prices remain buoyant, we advocate extreme caution with regard to high yield bonds.

It is our opinion, for what it is worth, that oil prices will remain high for years to come (see our March 2004 Newsletter for reasons). Having said this, nothing shoots up in a straight line. Many short term factors are contributing to the current spike in prices, and we would not be at all surprised to see prices come back down again later this year to $30-35 per barrel. Our long term target of $60-100 remains intact though. Consumers beware!

Reason # 3:

The combination of slowing profit growth and rising interest rates can be lethal. Usually, the profit cycle (as measured by the year-on-year change on a trailing four quarter basis) is highly correlated with short-term interest rates (as measured by the year-on-year change) - about 0.8 historically. In other words, when rates start to go up, as they usually do when the economy starts to come back to life after a recession/slowdown, the effect is mitigated by the fact that earnings are also accelerating. Improving earnings provide investors with some cushion and allow equity prices to go up despite rising interest rates – at least for a while.

The problem facing investors now is that rising oil prices and the dwindling effect of last year's tax cuts in the U.S. will most likely cause U.S. GDP growth to slow in the second half of this year, which again will impact Europe negatively. Meanwhile, the Fed, probably realising that they are a little bit "behind the curve", will most likely take Fed Funds rates moderately higher over the next several months.

A simultaneous occurrence of rising interest rates and slowing profit growth does not happen that frequently. But when it does, it often leads to unpleasant results. The bear market of 1990, the debt crisis in 1998 and the global collapse in stock markets in 2001/02 all occurred subsequent to rates going up while profits were deteriorating.

The effect is not always immediate though. It is not unusual for markets to shrug off the rise in rates, at least for a while. But, ultimately, investors may pay a dear price for ignoring this warning signal.

Reason # 4:

Demographic forces have a powerful impact on equity prices. In a study dated August 2002 [5], Geanakoplos, Magill and Quinzii demonstrate a powerful link between the age mix of the population and P/E ratios. They operate with a ratio named the MY-cohort ratio, which represents the mix of middle-aged to young people. Interestingly, but perhaps not so surprisingly, P/E ratios increase when the MY-cohort ratio is on the rise and visa versa - see Tables 4 and 5 below.

The authors conclude that when the middle-aged are outgrowing the younger generations, P/E ratios rise.

Table 4 – Number of Births in the U.S. and the Five Cohorts of the 20th Century

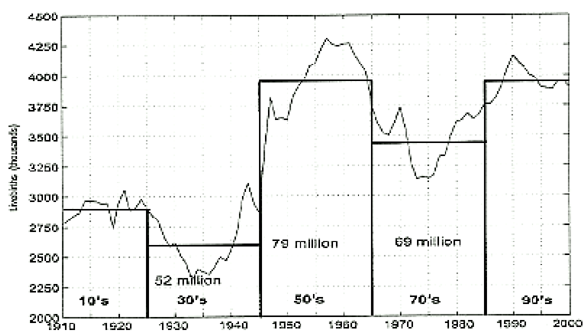
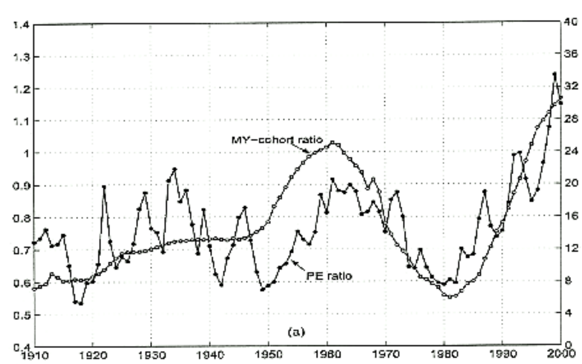


Table 5 – Real S&P P/E Ratio and MY Cohort Ratio



Unfortunately for the stock market, over the next 10 years, the MY-cohort ratio will drop by about 25-30%, suggesting a similar drop in P/E ratios.

[5] "*Demography and the Long-Run Predictability of the Stock Market*" by John Geanakoplos, Michael Magill and Martine Quinzii, Cowles Foundation for Research in Economics, Yale University.

If you find this hard to comprehend, think about it the following way. Most people go through cycles in terms of spending and saving. When you are young, you invest in the future. You buy property. You have children. You put money aside for their future education, etc.

When you move into the middle-aged groups, your spending and savings pattern changes significantly. Your job is better paid now. Your children leave home. You have considerably more money to invest in financial markets. The point is, if you are part of a large cohort (e.g. the baby-boomers), you are just one of many millions of people who find themselves in this situation. The end result? P/E ratios are driven higher, leading to higher returns on equities, until the cycle reverses. The great secular bull market of 1982-2000 is a perfect example of this relationship. During this 18-year period, the MY-cohort ratio more than doubled from 0.55 to 1.2, leading to the great expansion of P/E ratios.

An interesting consequence of this relationship is that people in small cohorts on average enjoy significantly higher life-time incomes than people in large cohorts. In their youth, they can borrow at lower interest rates. In their middle age, when they invest most of their money, interest rates are comparatively high and P/E ratios low. Furthermore, people in smaller cohorts face less competition for jobs and thus receive higher remuneration than do people in higher cohorts. Dear fellow baby-boomers, we were born at the wrong time!

Conclusion

So how do you position your portfolio to prepare it for a secular bear market in equities? We suggest the following lines of action:

a. Invest in value stocks rather than growth stocks. As P/E multiples come under pressure, value stocks offer much better protection. This is in fact precisely what has happened since 2000, where value stocks have significantly outperformed growth stocks.

b. Invest in companies that pay high dividends and/or companies that are very likely to raise dividends. High dividends offer some downside protection during difficult times. You will find that many of these stocks also qualify as value stocks.

c. Do not invest in interest rate sensitive and/or consumer cyclical companies. Invest in stocks with stable earnings.

d. Allocate more to energy stocks. If our long-term prognosis is correct, this will become one of the best performing areas within the stock market over the next 5-10 years.

e. Reduce the duration/average maturity in your bond portfolio. As we argued in last month's newsletter, the risk of interest rates rising significantly from current levels is probably higher in the U.S. than in Europe. Given our oil price outlook and the effect this may have on inflation, we would reduce the duration in a European bond portfolio nonetheless.

f. Exercise extreme caution as far as high yield bonds are concerned. Credit spreads tend to widen in times like this. There is no reason to be brave.

g. Include commodities in your asset allocation. Our work suggests that a 5-10% allocation to commodities brings great benefits to a portfolio consisting of traditional asset classes only.

h. Consider including hedge funds in your portfolio if you have not already done so. Many people, including some quite sophisticated investors, continue to be lukewarm on hedge funds. Do not think of hedge funds, though, as one asset class with a homogeneous risk profile. Some hedge funds are indeed very risky whilst others are quite conservative. Your portfolio will likely do a great deal better in a secular bear market, if you trade in your equity portfolio for a portfolio of conservative hedge funds.

i. Other non-correlated asset classes should also be considered. Think outside the box. Call us for details.

Dennis Gartman's Rules of Trading

Absolute Return Partners do not excel in trading strategies. We exclusively apply long-term investment strategies based on strategic as well tactical investment decisions. We do recognise, though, that many of our clients allocate significant amounts of time to trading. We would therefore like to introduce those of you who trade actively, to Dennis Gartman, who is one of the smartest traders on this planet. You can do worse than follow his trading rules, a selection of which we bring below. You can learn more about Dennis Gartman on www.alberdon.demon.co.uk.

1. Never, under any circumstance, add to a losing position. Nothing more need be said; to do otherwise will eventually and absolutely lead to ruin.

2. Capital comes in two varieties: Mental and that which is in your pocket or account. Of the two types of capital, the mental is the more important and expensive of the two. Holding to losing positions costs measurable sums of actual capital, but it costs immeasurable sums of mental capital.

3. The objective is not to buy low and sell high, but to buy high and to sell higher. We can never know what price is "low." Nor can we know what price is "high." Always remember that sugar once fell from $1.25/lb to 2 cent/lb

and seemed "cheap" many times along the way.

4. In bull markets we can only be long or neutral, and in bear markets we can only be short or neutral. That may seem self-evident; it is not, and it is a lesson learned too late by far too many.

5. "Markets can remain illogical longer than you or I can remain solvent," according to our good friend, Dr. A. Gary Shilling. Illogic often reigns and markets are enormously inefficient despite what the academics believe.

6. Sell markets that show the greatest weakness, and buy those that show the greatest strength. Metaphorically, when bearish, throw your rocks into the wettest paper sack, for they break most readily. In bull markets, we need to ride upon the strongest winds. They shall carry us higher than shall lesser ones.

7. Try to trade the first day of a gap, for gaps usually indicate violent new action. We have come to respect "gaps" in our nearly thirty years of watching markets; when they happen (especially in stocks) they are usually very important.

8. Trading runs in cycles: some good; most bad. Trade large and aggressively when trading well; trade small and modestly when trading poorly. In *"good times,"* even errors are profitable; in *"bad times"* even the most well researched trades go awry. This is the nature of trading. Accept it.

9. Respect "outside reversals" after extended bull or bear runs. Reversal days on the charts signal the final exhaustion of the bullish or bearish forces that drove the market previously. Respect them, and respect even more "weekly" and "monthly" reversals.

10. Keep your technical systems simple. Complicated systems breed confusion. Simplicity breeds elegance.

11. Respect and embrace the very normal 50-62% retracements that take prices back to major trends. If a trade is missed, wait patiently for the market to retrace. Far more often than not, retracements happen, just as we are about to give up hope that they shall not.

12. An understanding of mass psychology is often more important than an understanding of economics. Markets are driven by human beings making human errors and also making super-human insights.

13. Establish initial positions on strength in bull markets and on weakness in bear markets. The first "addition" should also be added on strength as the market shows the trend to be working. Henceforth, subsequent additions are to be added on retracements.

14. Bear markets are more violent than are bull markets and so also are their retracements.

15. Be patient with winning trades; be enormously impatient with losing trades. Remember it is quite possible to make large sums trading/investing if we are "right" only 30% of the time, as long as our losses are small and our profits are large.

16. The market is the sum total of the wisdom - and the ignorance - of all of those who deal in it, and we dare not argue with the market's wisdom. If we learn nothing more than this, we've learned much indeed.

17. Do more of that which is working and less of that which is not: If a market is strong, buy more; if a market is weak, sell more. New highs are to be bought; new lows sold.

18. The hard trade is the right trade: If it is easy to sell, don't; and if it is easy to buy, don't. Do the trade that is hard to do and that which the crowd finds objectionable.

19. Margin calls are the market's way of telling you that your analysis is wrong. Never meet a margin call. Liquidate your position instead.

Post Script

In the May 2004 issue The Forbes Magazine ran an article on hedge funds, which in our opinion is not only biased against hedge funds; it is actually full of factual errors. It is quite simply bad journalism.

We are tempted to comment on the article in length but realise that we can do no better than John Mauldin did in his May 21 newsletter titled "*The Sleaziest Journalism on Earth*". You can read John's response on www.frontlinethoughts.com or you can visit our web site www.arpllp.com (under Investor Perspectives). John can be reached on John@FrontlineThoughts.com.