The Big Picture

Has the market bottomed out? Is the recent market rise just a bear market rally? Should you wait a few months to see if the economy recovers before you invest? Questions abound as pundits in the media spew forth short-term prognostications. The Dow at 1000 or 10,000 – take your pick.

The truth is that no one can say with absolute certainty whether the recent market rally is temporary or the start of the next bull market. Market turning points look obvious in retrospect but this is due to hindsight bias, the tendency for investors to overestimate the predictability of events after the fact and gloss over alternative outcomes that might have occurred. For example, if the U.S. government had bailed out Lehman Brothers rather than let it fail, the paroxysm of fear that swept the credit markets and then triggered the massive stock sell-off last October may never have occurred and the recession may have been much milder.

Because stock prices reflect all available public information, the run-up in prices since the S&P 500 closed at 677 on March 9 undoubtedly reflects a growing consensus that the severity of this economic downturn is moderating and a recovery later in 2009 is becoming more likely. Recent aggressive actions by the Federal Reserve to support lower interest rates through further quantitative easing and the announcement of the Treasury's Public-Private Investment Program (PPIP) bolster this view.

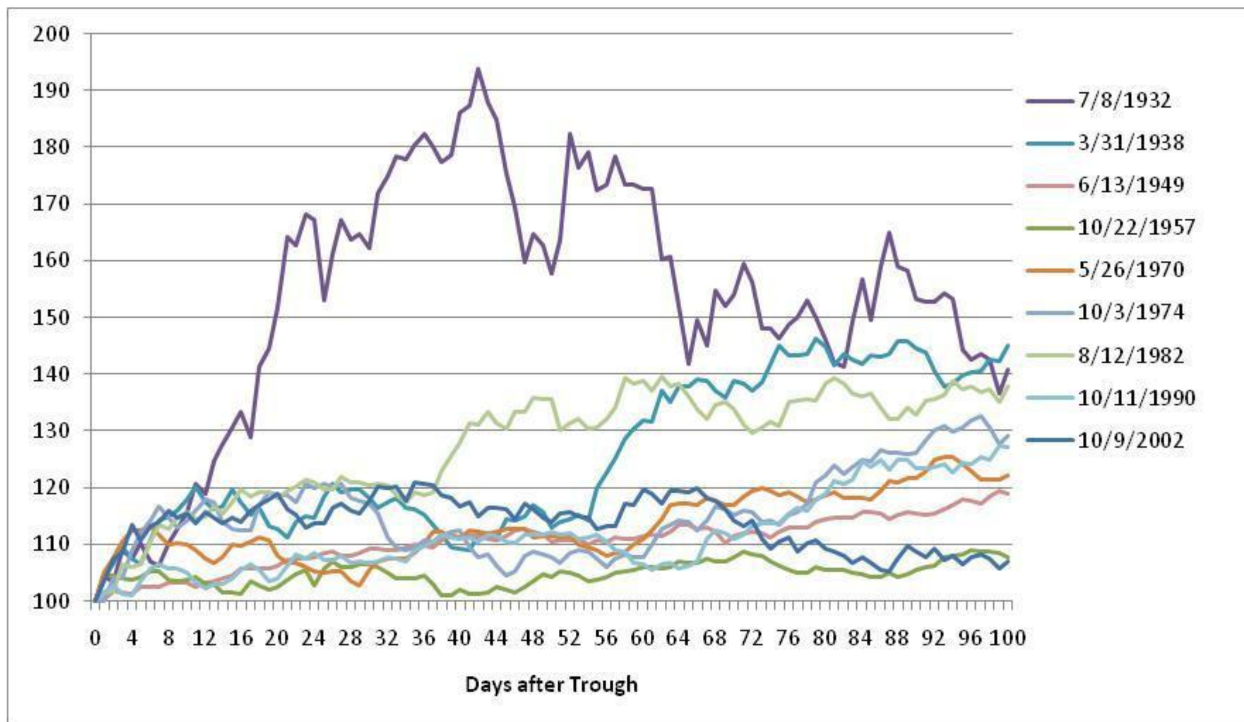
Yet, a second half economic recovery represents just one possible scenario, albeit the most probable if the stock market is to be believed. Continued declines in U.S house prices may forestall any meaningful recovery in the mortgage-backed securities market while rising credit card and bank loan delinquencies may also delay an improvement in the financial sector. Also, the PPIP may not be as effective as its proponents hope in removing toxic assets from bank balance sheets, impeding the availability of credit and further damaging confidence.

A study of banking crises by Professors Reinhart and Rogoff found that the associated downturns were prolonged affairs, lasting two years on average. In fact, over 20 percent of the business cycle contractions in the U.S. since 1854 have lasted longer than 18 months. Although these longer downturns were concentrated in the period before World War II, many were caused by banking crises and credit shocks similar to

our current situation. Hence, it is possible that a recovery may be delayed into 2010 and that the current market rally fades and the March low is retested or even breached.

Even if March 9 turns out to be a market bottom – an outcome for which we are all hoping – there can be a wide variation in the extent of subsequent price recovery. The following graph tracks the first 100 days of the price performance of U.S. large company stocks after the trough of the recession-induced bear markets since 1929.

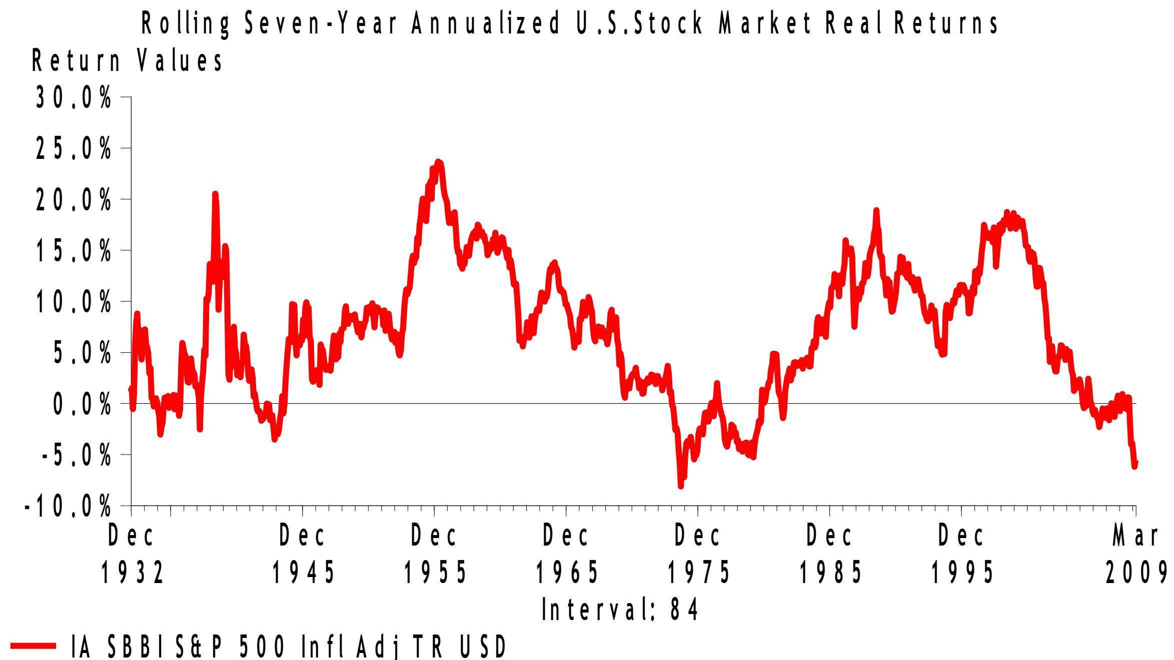
U.S Stock Price Performance
First 100 Days of Recovery



As can be seen, although stock prices on average rebounded 22 percent, the range of increases was from as low as 7 percent to as high as 45 percent.

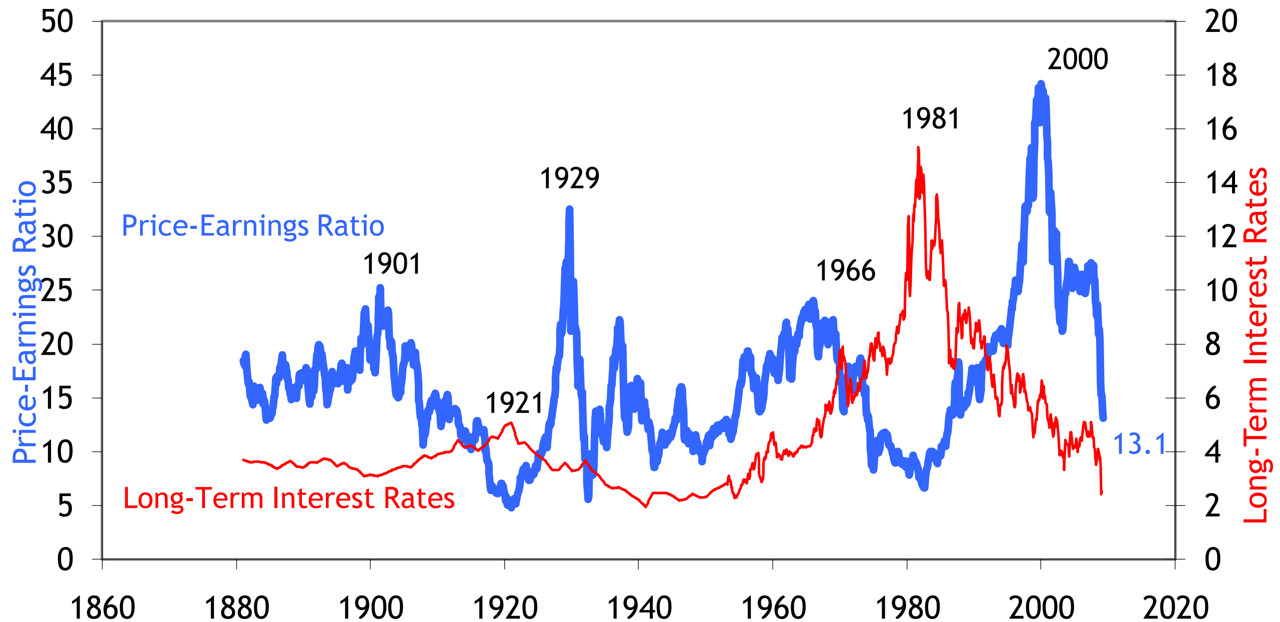
What becomes clear is that peering into the future to make short-term forecasts is not fruitful. Investors are better off focusing on the big picture of long-term return

potential. In this regard, the following graph illustrates the seven-year annualized rolling real returns of U.S. stocks since 1932.



The one-two punches of the “tech wreck” earlier this decade and the ferocious downturn since October 2007 has devastated returns over recent years. You have to go back to the 1930’s, the end of WWII or the mid-1970’s to get a similar negative result.

Fortunately, the corollary of a protracted period of dismal returns is attractive stock market valuations. The following graph sets out the rolling 10-year real price earnings ratio of the S&P 500 prepared by Robert Shiller, the noted finance professor who warned of the dangers of the excessive stock market valuations at the turn of the millennium and, more recently, of the now deflating U.S. housing bubble.



On an absolute basis, today's real price earnings ratio of 13.1 has not been this attractive since the early 1990's. However, interest rates for long-term government bonds then were double today's rates and as a result, on a relative basis, equity valuations today are actually much more compelling. Today's valuations are more akin to the early 1950's with the real price-earnings ratio in the low teens and interest rates in the low single digits. Other periods of similarity include the early 1940's, the mid-1930's, the early 1920's and the period just prior to WWI. These all represented attractive entry points for equity investors with a ten to fifteen-year time horizon.

Trying to peer through the fog of short-term market uncertainty is tempting, but it provides no helpful direction. The market may go up, down or sidewise for months or even years. No one knows. What is readily apparent is that investors today - unlike the exuberant years of the late 1990's or 1920's or the go-go era of the 1960's, all periods where individuals piled into stocks without a qualm - have the potential for rewarding long-term returns. Investors need to focus on the big picture.

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*- Interested readers can contact Tacita Capital for the academic sources and studies to which we refer.

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