MID-CONTINENT CAPITAL

CONSILIUM*

Volume 18—April 2014

*advice; judgment; resolution; wisdom

Bubbles and Bear Markets, Crashes and Corrections

The sharp rise in US stock prices since the Great Recession lows in 2009 has been met with a very high degree of skepticism, even though the most important underlying fundamentals – earnings, interest rates, and inflation have been exceptionally favorable. Specifically, since the previous market peak in 2007, S&P 500 earnings have risen by 36%, long-term interest rates (as measured by the 10-year US Treasury note) have declined from nearly 5% to 2.7%, and the inflation rate (year-over-year, as measured by the core Consumer Price Index) has dropped from 2.5% to 1.5%[1]. These three factors *should* have combined to produce very sharp gains, but the mere 20% increase in stock prices over a *seven-year* stretch is now being characterized by many pundits as a "bubble". What does a stock market have to do to earn any respect?

A subdued market environment in the quarter just ended (with the S&P 500 delivering a total return of 1.8%, the slowest pace in over a year) has not diminished enthusiasm for the term "bubble". According to Bank of America Merrill Lynch, press references to a stock market bubble are appearing twice as often as in 2007, and four times as often as in 2000. While difficult to justify, this is at least understandable; scarred by their failure to anticipate the disastrous 2008 financial meltdown, market observers are now trained to expect danger at every turn. The investing public appears to be of a similar mindset: half of the country believes that now is a "bad time to invest", compared to 41% at the 2007 peak and just 28% in 2000[2]. But bubbles happen when optimism is overwhelming, not when everyone is talking about bubbles!

This is not to deny that there aren't some "bubbly" pockets of excess investor optimism. Biotechnology and internet stocks, for example, have risen more than fourfold in the last five years. The frequency of and capital raised by initial public offerings are both at their highest levels since 2000. And market darlings such as Tesla, LinkedIn, Yelp, Netflix, Facebook, and Twitter (to name but a few) all command valuations that require extraordinary (and improbable) growth to be justified.

But unlike the circumstances in 2000, when technology stocks represented over a third of the S&P 500, internet and biotech companies today constitute just 8% of the broad stock market[3], making the indices much less vulnerable even if these groups were to decline sharply. Meanwhile, a variety of useful measures of stock market value – including ratios of price to earnings, cash flow, revenues, and book value – are all within reasonable distance of their average levels of the past 25-50 years[4].

If the market is not now a bubble, could one be developing? Much depends on whether economic growth improves from its recent, subdued pace, and how the markets respond. If a stronger economy generates stronger sales, earnings, and dividend growth, equity investors should earn good returns even without the benefit of a further rise in valuations. If the hoped for economic acceleration fails to materialize, equity investors can at least expect returns that are superior to fixed income alternatives – again, assuming no further rise in valuations. Ultimately, inflating a stock market bubble requires that investors be willing to uncouple share prices from underlying corporate performance. As suggested above, we see only limited evidence of this phenomenon. Our concern will rise if it becomes widespread.

Sources: [1]Baseline; [2]Gallup; [3]Bank of America Merrill Lynch; [4]Ibid

Please turn to next page

Note that these outcomes are tied to either slow economic growth or faster economic growth – but not outright contraction. In nearly all cases since the Second World War, market declines of more than 20% (a commonly agreed upon threshold that divides a "bear market" from a "correction") have occurred in anticipation of an economic downturn. At present, we are not aware of any early warning signs of a renewed slump in the economy (i.e., tightening credit conditions).

None of the foregoing discussion is intended to wave off the possibility of one or more meaningful corrections before the current market cycle has run its course. As recently as 2011, stocks fell by nearly 20% as concerns over the future of the European currency and banking system and fiscal deadlock in the US dominated summertime headlines. In 2012, stocks experienced two separate 10% pullbacks, driven by many of the same concerns. Stocks were able to recover fairly quickly each time because corporate profits continued to rise as the economy continued to expand.

The world offers nervous investors an ample array of worries at present:

- Has the recent spate of weak economic reports been due to unusually harsh winter weather, or something more fundamental? Can the US economy shift to a faster rate of growth, or is this the best we can do?
- Does Russia's recent incursion into Ukraine represent a renewed "imperialist" thrust, and will a new Cold War be the result?
- How severe is the economic slowdown in China, and how long will it last? When will other important emerging markets resume faster growth?
- The Federal Reserve appears committed to gradually ending its large scale bond buying operation over the next year. How soon thereafter will we witness what would be the first increase in short term interest rates since 2006? Can the stock market abide a "normal" interest rate environment?

Market corrections can occur at almost any time, and for almost any reason. It would be surprising indeed if 2014 passed without another decline that was long and/or deep enough to test investors' nerves. When it happens, we can confidently predict that:

- An array of prognosticators will step forward to explain what caused the decline, emphasizing factors that were completely clear – in hindsight.
- Many of the same pundits will herald the decline as the start of the next bear market.

In the current environment the combination of low inflation and interest rates, and tepid economic growth is just strong enough to propel earnings forward without threatening tight monetary conditions. This is very favorable for equity investors. Someday it will end, and stocks will be vulnerable to a large decline. But that moment does not appear imminent, and for that reason we expect any upcoming correction to represent a temporary pause.

150 S. Wacker Drive, Suite 400 ◆ Chicago, IL 60606-4101 ◆ Tel: 312.551.8200 ◆ Fax: 312.551.8780 ◆ mcclc.com