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It’s Not Over Yet

How, when and why this bull market will *really* end

Highlights

■ Notwithstanding the current or any subsequent correction, this bull market is unlikely to end any time *soon* with a *sharp* collapse.

■ Why does a bull market end? It’s usually due to war, high inflation, or financial panic. The surprise ending to this bull market may be that because there is no such event there is no traditional bear market decline of 20%+. Instead this bull market may eventually simply stop going up for a prolonged period of time, or decline modestly.

■ Bear markets normally involve a collapse in P/Es, not earnings, but no such P/E collapse is likely in this cycle. Inflation will stay low on a *secular* basis, as the Fed gradually tightens to curb *cyclical* inflationary pressures. As economic growth slows, earnings will decline but P/Es will not contract much because bond yields will decline during the economic downturn.

■ The early 1990s resemble the early 1960s in that we are in a relatively long earnings-driven bull market with low inflation. But in the 1990s there are key differences that argue for the decade ending very differently than the 1960s.

- Much less complacency that rapid growth and low inflation can continue indefinitely;
- Less risk of "cost-push" inflation because of weaker unions, greater foreign competition; and
- In 1960s Democrats believed they could boost living standards of workers by driving down unemployment rate, even at the risk of higher inflation. Democratic administrations now know this to be untrue, because real wages plunged when inflation picked up in 1970s.

We are likely in a correction in a bull market—not a classic bear market decline of 20% or more. And by historical standards we were due for a downturn. We have gone 39 months without a year-to-year decline in the DJIA, calculated on a monthly basis (Table 1). Such declines do not inevitably become bear markets. After such periods on average the market has been only 8% off that level twelve months later, and in the post-war period only off 2%. Twenty-four months later stocks were 3% *above* the prior level on average; 7% above the prior level in the post-war period.

Popping the bubble

When the Federal Reserve tightened monetary policy for the first time in 58 months, it startled investors who had grown accustomed to low and stable rates. A complacent and over-bought bond market cratered—even though recent news on the inflation front has been excellent, what with CPI numbers looking good and oil prices tumbling.

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Table 1
Periods of 24 months or more without a year-over-year decline in Dow Jones Industrial Average
On a monthly basis

	Number of months	% change, DJIA	Change per month
Aug 1904 -Dec 1906	29	76.3%	2.63%
June 1924-Dec 1926	31	63.1	2.04
Feb 1927-Oct 1929	33	68.9	2.09
Apr 1935-Aug 1937	29	62.1	2.14
Nov 1942-Aug 1946	46	65.2	1.42
Sept 1949-Mar 1952	31	47.6	1.54
Jan 1954-Oct 1956	34	64.1	1.89
Apr 1963-Apr 1966	37	30.1	0.81
Dec 1970-Mar 1973	28	13.4	0.48
Jan 1985-Oct 1987	34	54.9	1.62
Jan 1991-Mar 1994	39	32.9	0.84
Average	34	52.6%	1.59%

The violent reaction of the bond market to Fed tightening—which took Mr. Greenspan by surprise—actually demonstrates that the Fed tightening move was *healthy.* It popped a rather large speculative "bubble" that had developed in the bond market as hedge funds and other traders aggressively played the steep spread between short-term and long-term interest rates. The recent experience of Japan—not to mention the U.S. in 1929, when easy money was buoying the stock market—demonstrates the danger of permitting financial bubbles to become too immense. It is far better to pop the bubble at a stage when it hurts the "fast money" in the financial markets, but not institutions directly tied to the real economy, such as commercial banks.

A correction for stocks, not a bear market

Equity investors are understandably concerned by the rise in bond yields and have focused on this development rather than the fact that a stronger economy will generate higher profits. Investors also wonder whether a White House preoccupied by Whitewater can handle foreign policy challenges in Korea, Russia, the Mideast and elsewhere.

But despite the rise in interest rates and the political uncertainties, this does not look like true Bear Market territory. Inflation is under control, profits are rising nicely, and while stocks are modestly overvalued relative to bonds—after their recent rate surge—they are still cheap relative to cash. But, the classic causes of bear markets—war, financial panic, and reinflation—do not seem likely. To put the current stock market turbulence in perspective, it is useful to remember that in recent years we have frequently experienced nasty stock market spills that did *not* turn into full-fledged bear markets. Specifically:

- In the first half of 1984 the DJIA fell 15.6%, because the economy was surprisingly strong and the Fed was tightening. Investors feared that inflation would pick up and we would have a short, swift economic expansion followed by recession. But in fact economic growth slowed, inflation stayed low, the Fed eased, and stock prices rebounded in the second half of the year.
- In October 1989 the DJIA fell 8% in just a few days, with the marked plummeting 191 points on "Friday the thirteenth"—the day the UAL leveraged buyout collapsed. The market was 7% higher by the end of the year.
- In the autum of 1991 the Dow declined 213 points or 6.9% in 8 weeks. Of this decline, 120 points occurred in a single day, when investors reacted to Senator Alfonse D'Amato's proposal that credit card interest rates be capped. This would have disrupted consumer credit flows in a weak economy while damaging the profitability of an already-weak banking industry. And, then as now, a variety of other concerns worried investors, including fears of a "double-dip" recession (akin to today's fears of a runaway economy), the bursting of a bubble in biotech stocks (akin to recent malaise in emerging market stocks), and rumors of chaos in the Soviet Union (sound familiar?).
- From June to October 1992 the DJIA declined 8.1% as investors fretted about the prospect of a Clinton Presidency. Clintonomics—as interpreted by a rather suspicious Congress—has proved to be quite benign for stocks and bonds. This was a case of "sell on the campaign, buy on the election;" the DJIA rose 6.0% in the six months after election day.

This bull market will not end with a bang

The Fed's recent interest rate increases are a preemptive strike against inflation, an effort to slow economic growth before it produces inflation. Mr. Greenspan's anti-inflation vigilance offers an important clue both as to how the current bull market will proceed after the correction is over, and also how the bull market will end. Although it may be hard to believe after the market action of the last couple of weeks, neither the rest of this bull market nor its demise will be very dramatic.

We will not experience the thrilling P/E expansion of the 1950s and the 1980s, because P/Es are already fairly high. We will not experience the terrifying collapse of P/E ratios (and stock prices) of 1973-74, because inflation will stay low on a secular basis. We will not experience the financial panic of 1987, because regulators and investors are alert to that danger and Wall Street is no longer awash in risky financial innovations. Nor will we experience the calamitous debt deflation and economic collapse of the 1930s, which the Fed skillfully fended off during the banking crisis of 1989-90.

What we will experience instead is an uninspiring climb to higher stock prices, driven by higher earnings. The next few years will be similar to the years 1963-65, when inflation was low, economic performance was good, earnings were climbing, but stock market performance was far from spectacular because P/Es had already made a major move upward in the 1950s.

Unlike the 1960s, however, the current earnings-driven bull market will not be ended by high inflation that ultimately leads to a bear market. Far more likely, it will be interrupted by a moderate and unspectacular decline in stock prices as the Fed tightens to slow GDP growth and halt a potential *cyclical* (not secular) pick-up in inflation.

Why does a bull market end?

It's usually due to war, high inflation, or financial panic.

War, including the War of 1912, the Civil War, World War I (the NYSE closed for four months when hostilities commenced, but recovered during the war), World War II, and—to some extent—the Vietnam War.

Financial panics, which ended bull markets in 1836, 1854, 1873, 1893, 1920, 1929, and 1982. Typical elements of panics are a tightening of credit, a series of bank failures and other bankruptcies, a plunge in confidence in financial markets, a decline in commodity prices, and a recession. Most panics do not, however, plunge the economy into a lengthy depression. This occurred between 1836 and 1845 and during the 1930s because errors by regulators allowed the U.S. banking system to collapse, which in turn triggered a major monetary contraction.

Inflation, which killed off the long bull market of 1950-66. Though the Vietnam War was certainly a trigger of the secular inflation that began in the mid-1960s, there were more powerful, fundamental causes.

Price of the Dow Jones Industrial Average, 1790-1994

Turning points in the U.S. stock market

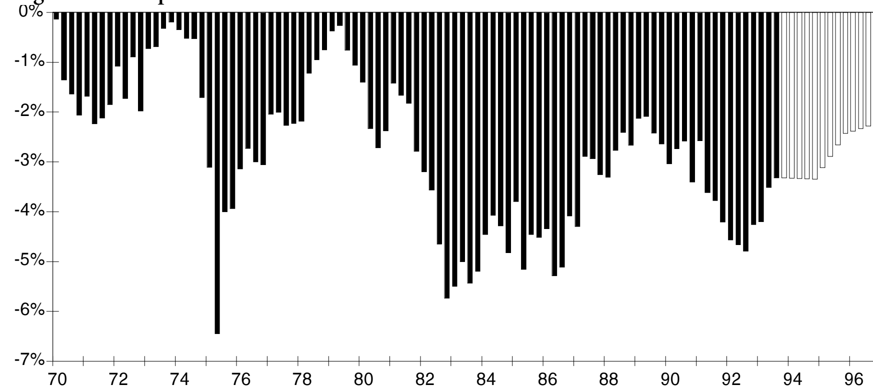
	Date	Event
A	1790: Trough	Federal government takes shape: Alexander Hamilton's pro-business policies, French Revolution create prosperity.
B	1812: Peak	War of 1812 begins.
C	1814: Trough	War of 1812 ends.
D	1836: Peak	Andrew Jackson kills Bank of the United States ending all monetary restraint. Second worst U.S. depression soon begins.
E	1844: Trough	Recession bottoms out. Boost in money supply via California gold discovery stimulates recovery.
F	1854: Peak	Railroad building boom ended by financial panic. Civil War (1861) extends slump.
G	1863: Trough	Civil War ends. Price stability and Republicans' pro-business policies spur railroad boom and bull market.
H	1873: Peak	Bankruptcy of Jay Cooke, promoter of Northern Pacific, precipitates financial panic, depression.
I	1879: Trough	Depression slowly ends, but price deflation continues until 1896.
J	1893: Peak	Financial panic precipitates short depression.
K	1897: Trough	Bull market begins. Deflation ended by gold discoveries in Alaska and South Africa. Confidence restored by defeat of agrarian populist William Jennings Bryan in 1896 elections. Merger boom of 1898-1903.
L	1909: Peak	High tide of prosperity during Taft administration, following brief panic of 1907. Decline in securities prices exacerbated by World War I.
M	1914: Trough	Outbreak of WW I shuts down NYSE for 4 months. Securities prices revive as it becomes clear that Wall Street will prosper by serving as Europe's banker.
N	1919: Peak	Inflationary business boom following war.
O	1920: Trough	Federal Reserve kills postwar inflation with brief recession.
P	1929: Peak	Stock market crash of October follows onset of recession several months earlier.
Q	1933: Trough	Nadir of Great Depression as Franklin Roosevelt takes office, declares banking holiday.
R	1937: Peak	After rising during economic expansion of mid-thirties, stock prices are depressed by new recession, World War II and postwar inflation.
S	1950: Trough	Great postwar bull market begins, sustained by disinflation, modest economic growth, in 1950s. Growth accelerates in 1960s.
T	1966: Peak	As Vietnam War accelerates, bull market ended by rising inflation, higher interest rates, slower productivity growth, social discord.
U	1982: Trough	Paul Volcker's war on inflation, Ronald Reagan's pro-business policies kick off new secular bull market.
V	1987: Peak	Market peaks in August as strong growth, rising interest rates, big current account deficit and weak dollar trouble investors.
W	1987: Trough	Market bottoms after October panic because Fed eases, economic expansion continues, stock valuations are reasonable.

Financial panic?

The risk that this bull market will end in another financial panic, a la 1987, is very low.

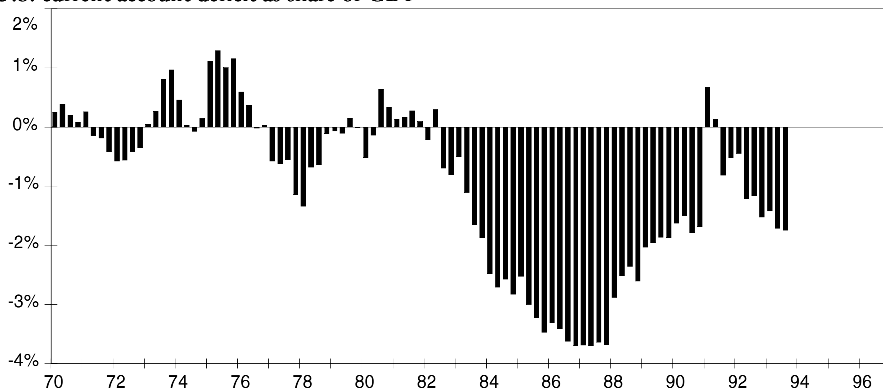
Versus 1987 the budget deficit has improved . .

Budget deficit as percent of GDP



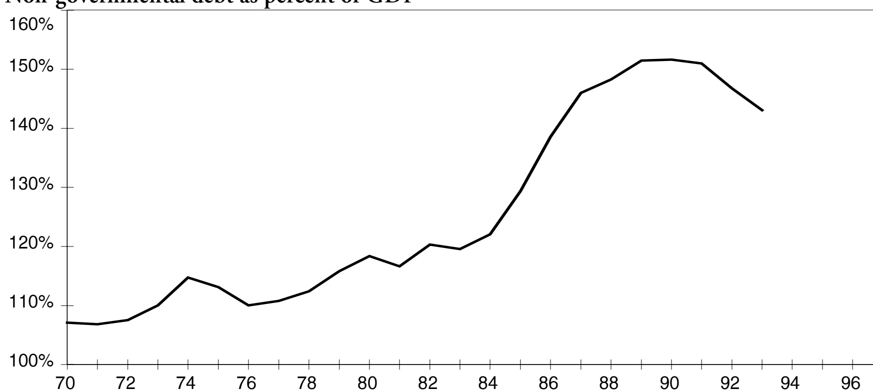
. . . as has the current account . . .

U.S. current account deficit as share of GDP



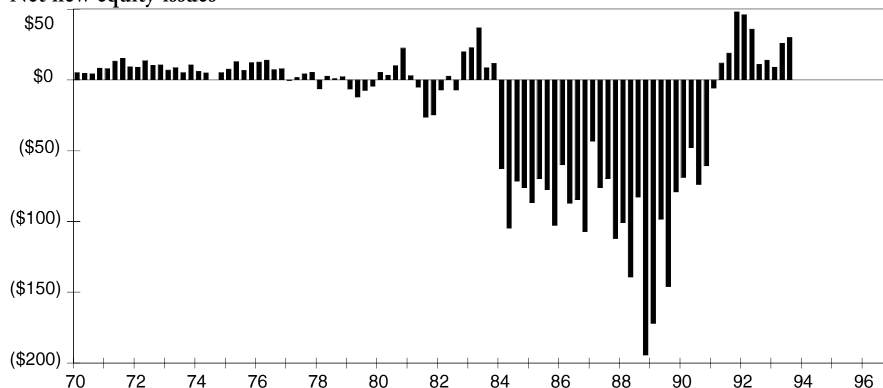
. . . . and the growth of non-governmental debt.

Non-governmental debt as percent of GDP



The myth of the shrinkage of the equity market has also dissapeared.

Net new equity issues



Inflation?
The 90's and the 60's

The 1990s resemble the early 1960s in that we are in an earnings-driven bull market with low inflation.

But in '90s there are three key differences.

Much less complacency that rapid growth and low inflation can continue indefinitely.

Trading Up

More Consumers Seek Frills, Higher Quality In Personal Purchases

Sales of Color TVs, $100 Suits And Fancier Autos Spurt; Penney's Adds a $5 Shirt

Is It an 'Indiscreet' Spree?

The Wall Street Journal, May 18, 1964

At Rainbow's End

Color TV Makers May Double '65 Sales in '66, but Won't Catch Demand Until '67

The Wall Street Journal, April 12, 1966

GM Says It Will Work For Price Stability
But Declines to Discuss Quotes on '65 Cars

The Wall Street Journal, May 15, 1964

STATE OF BUSINESS

Whatever Happened to the Business Cycle?

Time, June 5, 1964

The Guns, Butter, and Then-Some Economy

Fortune, October 1965

Soaring—and then some

The decade began with some bumps, but it's now plain that U.S. capitalism has learned a lot about itself—-and the economic policies that nourish it.

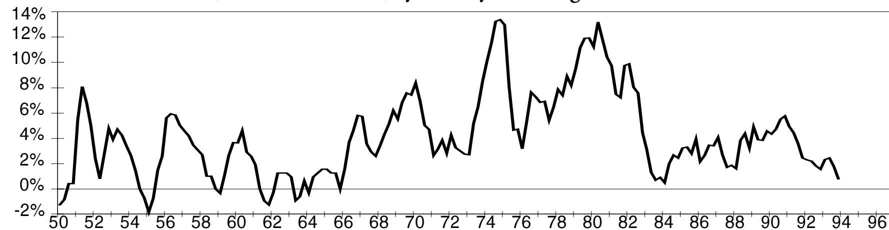
Business Week, July 16, 1966

HOW THE OLD POLITICS SWAMPED THE NEW ECONOMICS

Three years of mismanagement led to a fiscal and monetary crisis. It is relieved by the tax increase but the timing threatens trouble for the next Administration.

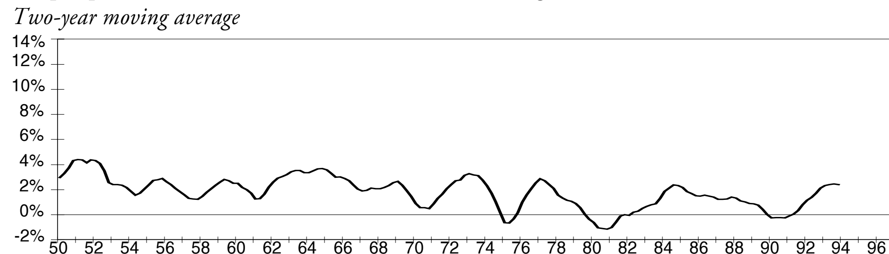
Fortune, September 1968

U.S. unit labor costs (nonfarm business): year-to-year change



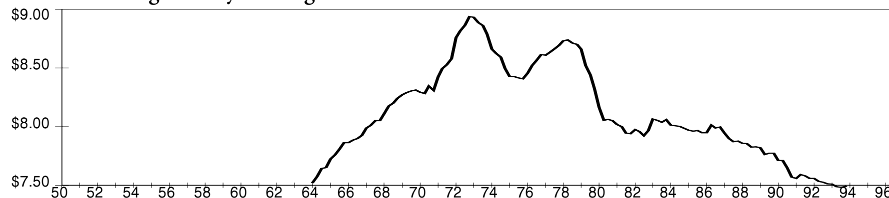
Less risk of "cost-push" inflation because of weaker unions, greater foreign competition.

Output per hour (nonfarm business): year-to-year change
Two-year moving average



In 1960s Democrats believed they could boost living standards of workers by driving down unemployment rate, even at the risk of higher inflation. Democrat Administrations now know this to be untrue, because real wages plunged when inflation picked up in 1970s.

U.S. real average hourly earnings: Level

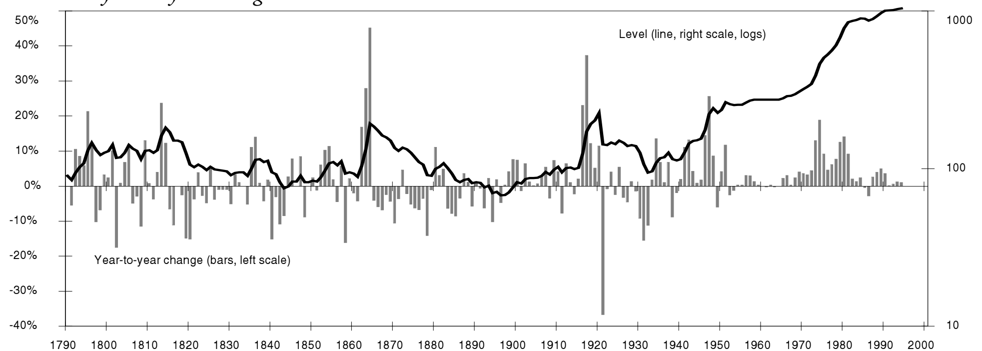


Inflation?

Secular inflation is not the norm in U.S. history; the PPI was no higher in 1930s than the 1790s.

U.S. Producer Price Index, 1790-1994

Level and year-to-year change



The Global Factors

Global disinflationary forces have an increasing impact on the U.S. economy.

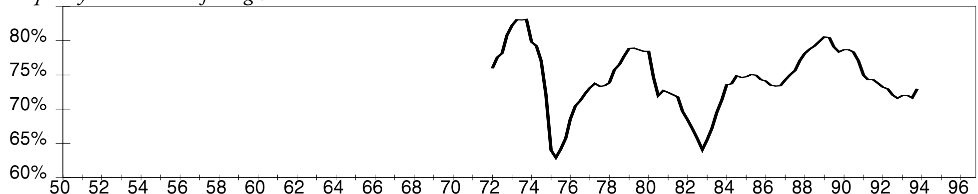
Central government deficit/surplus of major industrialized nations

Surplus (+) or deficit (-) as a percentage of nominal GDP

	1989		1992	1993	1994	1995
United States	-2.3%		-4.6%	-3.7%	-2.9%	-2.5%
-- excluding social security	-3.4		-5.4	-4.4	-3.8	-3.5
Japan	-1.2		-1.9	-2.6	-3.0	-3.0
Germany	-0.9		-1.3	-2.2	-2.1	-2.0
France	-1.5		-3.3	-4.7	-4.9	-4.7
Italy	-9.4		-10.5	-9.7	-8.8	-7.4
United Kingdom	+0.9		-6.2	-8.3	-7.4	-6.7
Canada	-3.2		-3.8	-4.2	-3.3	-2.4
Total of above Countries	-2.3%		-4.2%	-4.2%	-3.8%	-3.4%

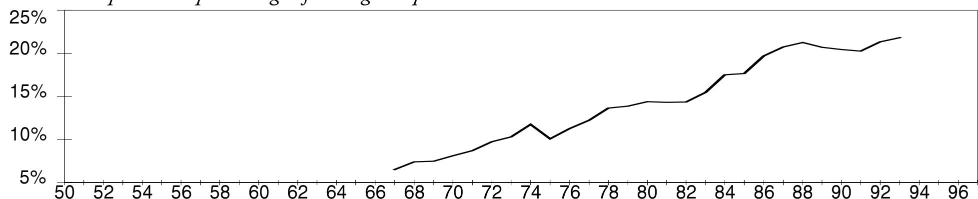
Global capacity utilization

Capacity utilization of "Big 7" economies



U.S. import penetration

Non-oil imports as a percentage of total goods production



Bear Markets, P/Es & inflation

Bear markets normally involve a collapse in P/Es, not earnings, but no such P/E collapse is likely in this cycle. Inflation will stay low on a *secular* basis, as the Fed gradually tightens to curb *cyclical* inflationary pressures. As economic growth slows, earnings will decline but P/Es will not contract much because bond yields will decline during the economic downturn.

Bull Markets		
	EPS	P/E
1926-1929	+29.8%	+22.2%
1932-Q1 '37	+170.7	-4.2
Q1 '38-Q2 '46	-13.4	+148.9
Q2 '49-Q4 '65	+116.3	+201.7
Q3 '66-Q4 '68	+4.5	+29.5
Q2 '70-Q4 '72	+16.3	+39.4
Q3 '74-Q1 '81	+60.3	+32.9
Q2-'82-Q3 '87	+27.7	+130.0
Q4 '87-Q1 '94	+53.9	+22.3
mean	*+51.8%*	*+69.2%*
mean since '49	*+46.5%*	*+76.0%*

Bear Markets		
	EPS	P/E
1929-32	-74.5	+26.1
Q1 '37-Q1 '38	-12.6	-45.6
Q2 '46-Q2 '49	+185.7	-73.0
Q4 '65-Q3 '66	+6.2	-21.9
Q4 '68-Q2 '70	-4.2	-26.7
Q4 '72-Q3 '74	+41.9	-62.0
Q1 '81-Q2 '82	-2.8	-16.8
Q3 '87-Q4 '87	0.0	-23.3
mean	*+17.5%*	*-30.4%*
mean since '49	*+8.2%*	*-30.1%*