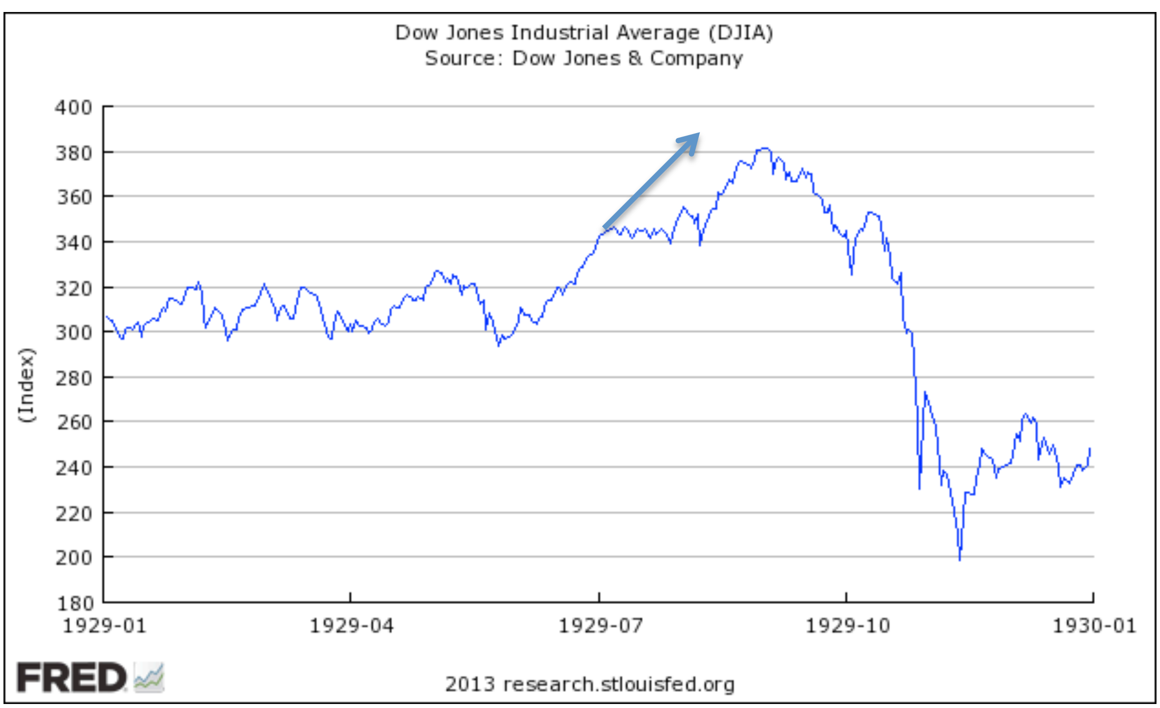
The Starboard Side Report

The week ending July 26, 2013

Two weeks ago we provided a detailed study about how the middle of July ended major rallies in 1998, 2007 and 2011. The market fell slightly this week, so it's still too soon to determine if we are going to get the big mid-July market top seen in those years. Should the market power through to new highs over the remainder of July and August, we wanted to see what could be is store. To help see where we may go from here should the market continue to rally, we once again will use one of our favorite teaching guides; history. We screened the past 100 years of market data in order to look for the following criteria. It had to be: 1) the first year of the US Presidential election cycle; 2) The market had to gain more than 10% in the first half of the year; 3) the market had to be significantly overvalued. We define significantly overvalued as having an estimated annualized return of less than 0% according to the Butler & Philbrick study that we include below. This year is the 26th presidential cycle since 1913, so that automatically narrowed our sampling size from the start. Of the other twenty-five examples that we studied, only two years (1929 and 1997) met the three criteria we sought.

1929 might be the only time in history when asset market speculation and credit excess were as large as they are at present. The great crash of 1929 was first and foremost a credit market event that spilled over into the stock market and then the economy.

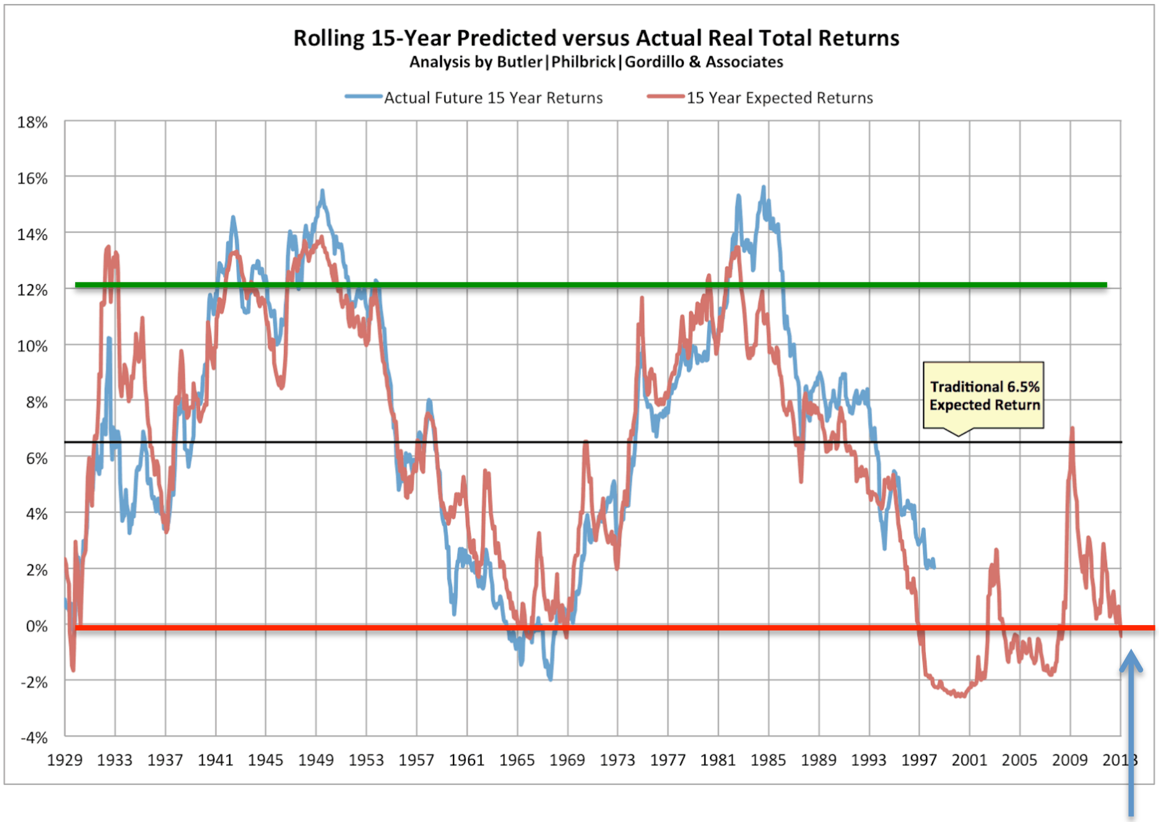
1929 Dow Jones Industrial Average



The arrow in the middle of the chart shows that the 1929 market gained another 3.6% in August before peaking on the first day of September. The Dow would go on to lose 40% of its value over the next two months and 83% over the next two years. Even though the argument can be made that the US stock market is not as speculative as the 1929 market, the real trouble today is the culture of speculation rampant in the credit markets. We are at the tail end of a historic credit bubble that will have huge ramifications for the US economy and stock market once it has finally popped for good. It appeared as if the system was going to be restructured in 2008, but the Federal Reserve managed to get the credit markets off of their deathbed for one more trip on the merry-go-round. Doug Noland of the Federated Investors recently tried to quantify the enormous size of the historic asset inflation that has gone on in the US by gathering the total "market risk" of the US economy. This "market risk" consisted of the value of all US Treasury debt, Asset Backed Securities, Corporate Bonds, Municipal debt and US equities. In 1990, market risk was $10 trillion dollars versus $62 trillion at the end of 2012 (an increase of 515%). The absolute number is not as important as the GDP (economic output) underlying that market risk. Not surprisingly, this is where the problem comes in. Over that same 22-year span, US GDP has only grown by 180% (again, versus 515% for market risk). We have gone from asset market risk being 1.8 times GDP to almost 4 times today! For too many years now, asset market inflation has soared well above what the economy can sustainably support. There is simply not enough collateral/productive output underlying this huge amount of market risk. Please keep in mind, this 1929 analogy is not a prediction, but merely a warning as to the dangers of chasing asset prices higher when they are similarly overvalued and disconnected from their underlying fundamentals.

1997 was other end of the spectrum from 1929 in that a severely overvalued market did not roll over and die. Instead, the market chopped around and ultimately *went nowhere for over a year*, but then launched into one of the greatest bubble peaks that the world has ever seen. Investors that are aggressively buying stocks at these levels are making a bet that the US Federal Reserve is going to be able to inflate another stock market bubble just thirteen short years after the greatest bubble of all time (before that bubble has even fully mean-reverted). It usually takes at least a generation to rid the excesses caused by a bubble, but given the upward trajectory to stock prices, many must believe it is about to happen all over again. To see what we mean, let's start with a look at how the market is priced on a historical basis.

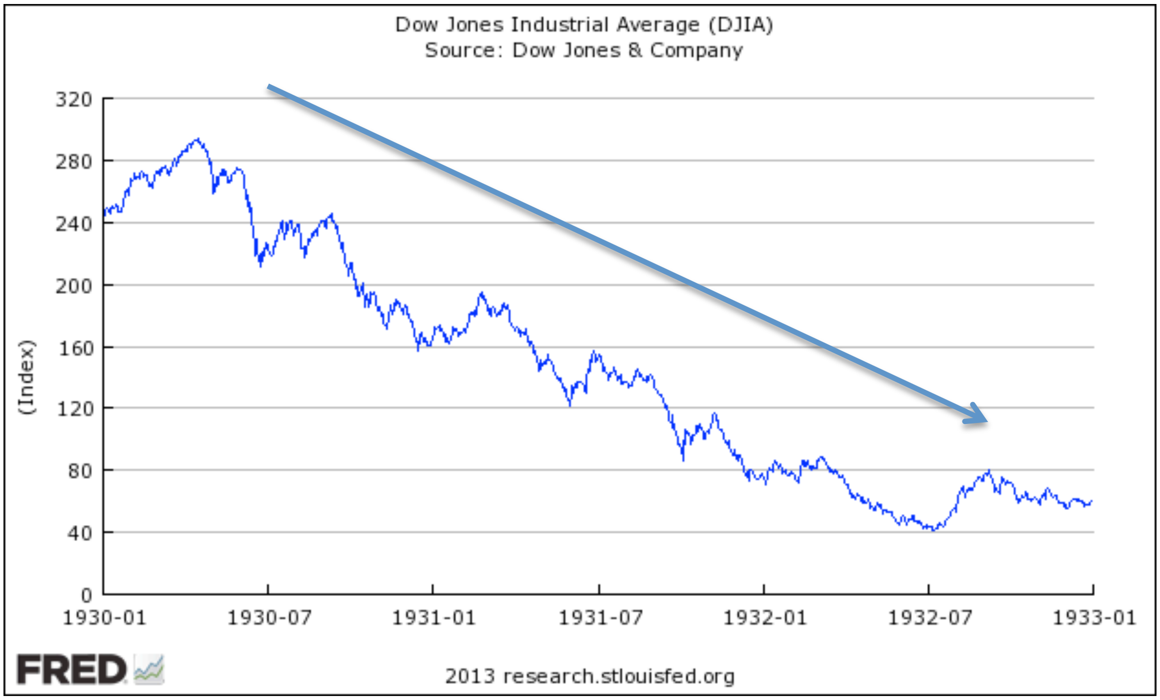
US Stock Market Expected Annual Returns (red chart line)
Vs.
US Stock Market Actual Annual Returns (blue chart line)



Here we are again
priced for perfection

The past two bear markets in history were between 1929-1950 and 1966-1982. By the time all was said and done, a full bear market revision took expected annualized returns in each of these episodes from below zero (red horizontal line) all the way up above 12% (green horizontal line) The US stock bear market that began in 2000 only took stocks back to their historical expected return of 6.5% (black horizontal line). So not only have we not experienced a full mean reversion, but we are now back to valuations that signaled the START of the 1929 and 1966 bear markets (that lasted 20 and 16 years respectively). Again, the only way that stocks meaningfully rally from here is if we are heading into another stock market bubble. That seems like an unusually poor bet for investors to make. Below are the divergent paths that the 1929 and 1997 episodes took in the subsequent three years.

THIS WAY (1929 - 1933 bear market)



OR

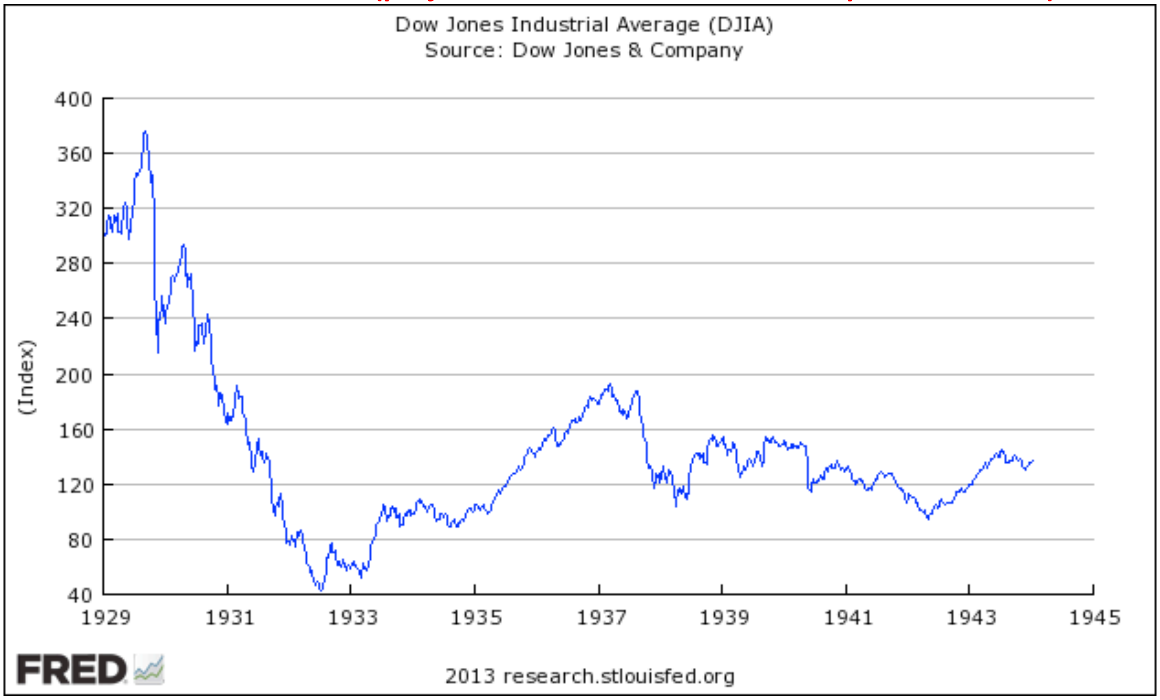
THAT WAY (1997 - 1999 bubble)……

The bottom line is that we are at a key inflection point. Either the markets are about to start another nasty bear market cycle that wipes 40 – 60% off of the value of the major stock market indexes or we are about to kickoff a blow-off bubble phase. We would rather miss a bubble than get caught in a 1929, 1969, 1974, 2001 or 2008 style market wipe out. Why might you ask would that be the case? The simple answer is that those that paid attention to valuation and did not participate in the last two years of the stock market bubble in 1998 and 1999 got two more opportunities over the next decade to buy stocks ***cheaper*** than they were in August of 1997. The S&P 500 was at 950 on August 1997 and eventually went to 1550 by March of 2000. Yet, you could have bought the S&P Index at 768 in October 2002 and at 666 in March of 2009. The market has always eventually bailed out investors that have remained conservative at valuations that exist at present.

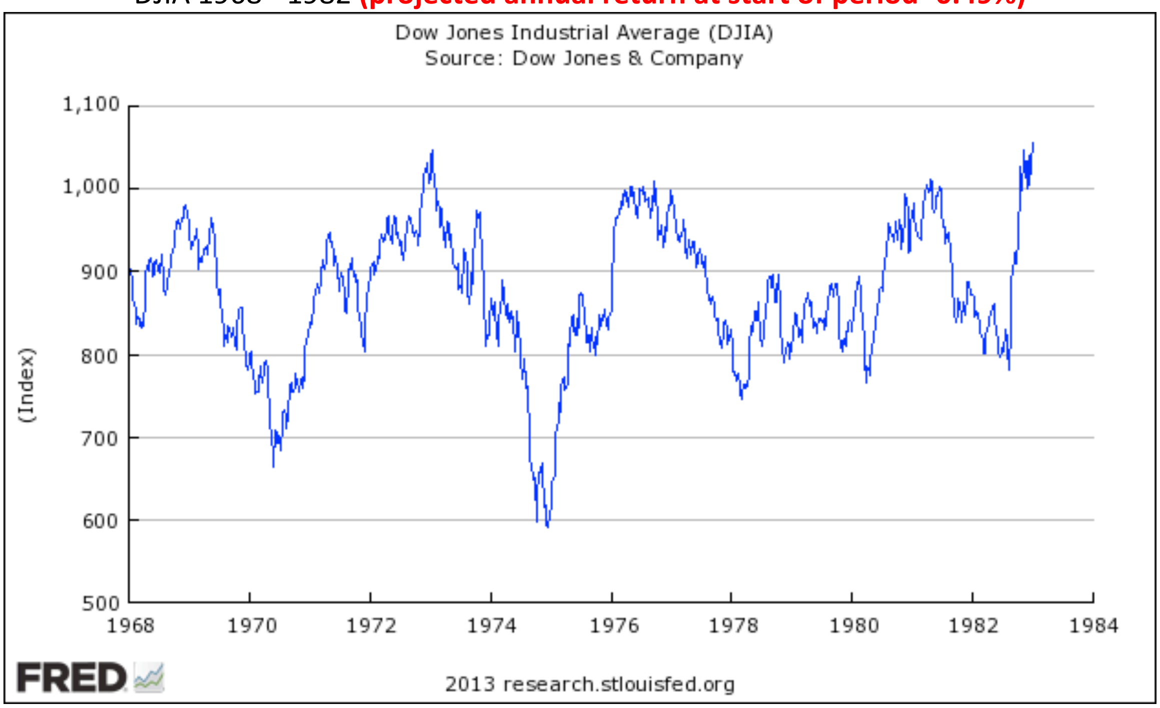
S&P 500 (August 1997 – March 2009)

The 1997 through 2000 bubble was the exception in history. The normal short-term price action has not nearly been as rosy when the market gets this overvalued. Here are two other examples and the 15 years that followed when overvaluation levels were similar to the present in 1929 and 1968. Right now, the Butler, Philbrick model is forecasting at least a negative 1.0% annual return versus negative 1.67 at the top in 1929 and negative 0.49 at the top in 1968. The Federal Reserve can try to suppress mean reversion and volatility all they want, but the market has always found a way of winning out in the end. Betting on a bubble is a very risky proposition at this juncture.

DJIA 1929 - 1943 **(projected annual return at start of period= -1.67%)**



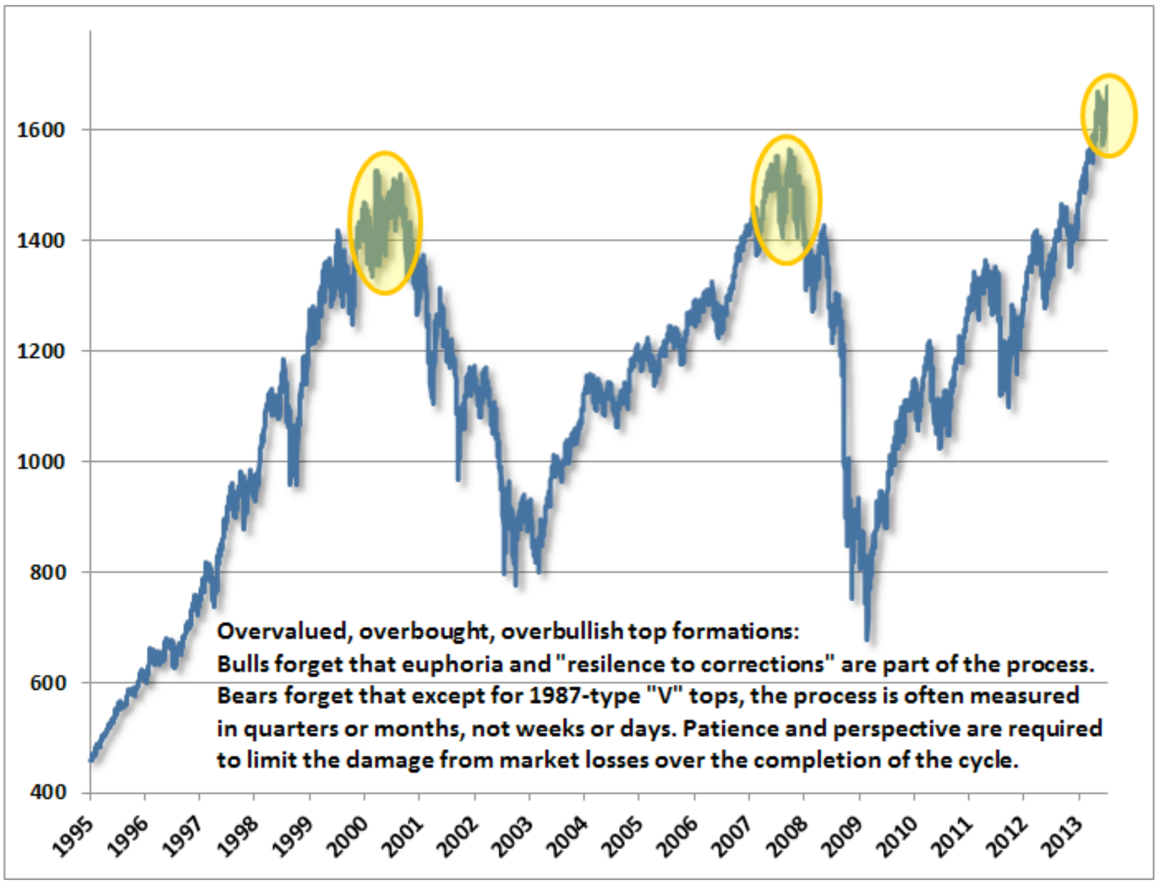
DJIA 1968 - 1982 **(projected annual return at start of period -0.49%)**



Looking at those pictures it should be obvious why we see chasing stocks higher at these nosebleed levels as a losing proposition. It is either going to turn out bad very shortly like 1929 & 1968 or eventually like 1997. The odds point to the former scenario being the more likely resolution. Either way, there has never been a situation in over 100 years of market history where you did not get a chance to buy stocks *meaningfully* cheaper than they are at present. By meaningful, we mean *at least* 25% cheaper. It seems as if greed and the fear of missing out, which have been suppressed after two massive wipeouts in the past 13 years, are coming back with a vengeance. The higher the market climbs, the more people are throwing in the towel and wanting to jump aboard the momentum train. The "hook" to this cycle is that the Federal Reserve won't let stocks fall. We have seen this movie before and know how it ends. The absolute levels of stocks would not be a big deal if valuations were priced to provide solid annual returns going forward. But, at negative annualized returns forecasted out 15 years into the future, it seems as if investors are taking insane amounts of risk for the third time since 2000.

Here We are Again!

S&P 500 (1995 – Present)



Source: John Hussman