

Understanding secular & cyclical markets – and their implications. (abbrev)

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Secular & cyclical markets - an important conceptual framework - helps you understand markets - helps you and I have a conversation about investments - helps us get much better returns

Particularly at this point in markets, this paper should help you understand the importance of some key steps we need to take to get a good result from our portfolios because:-

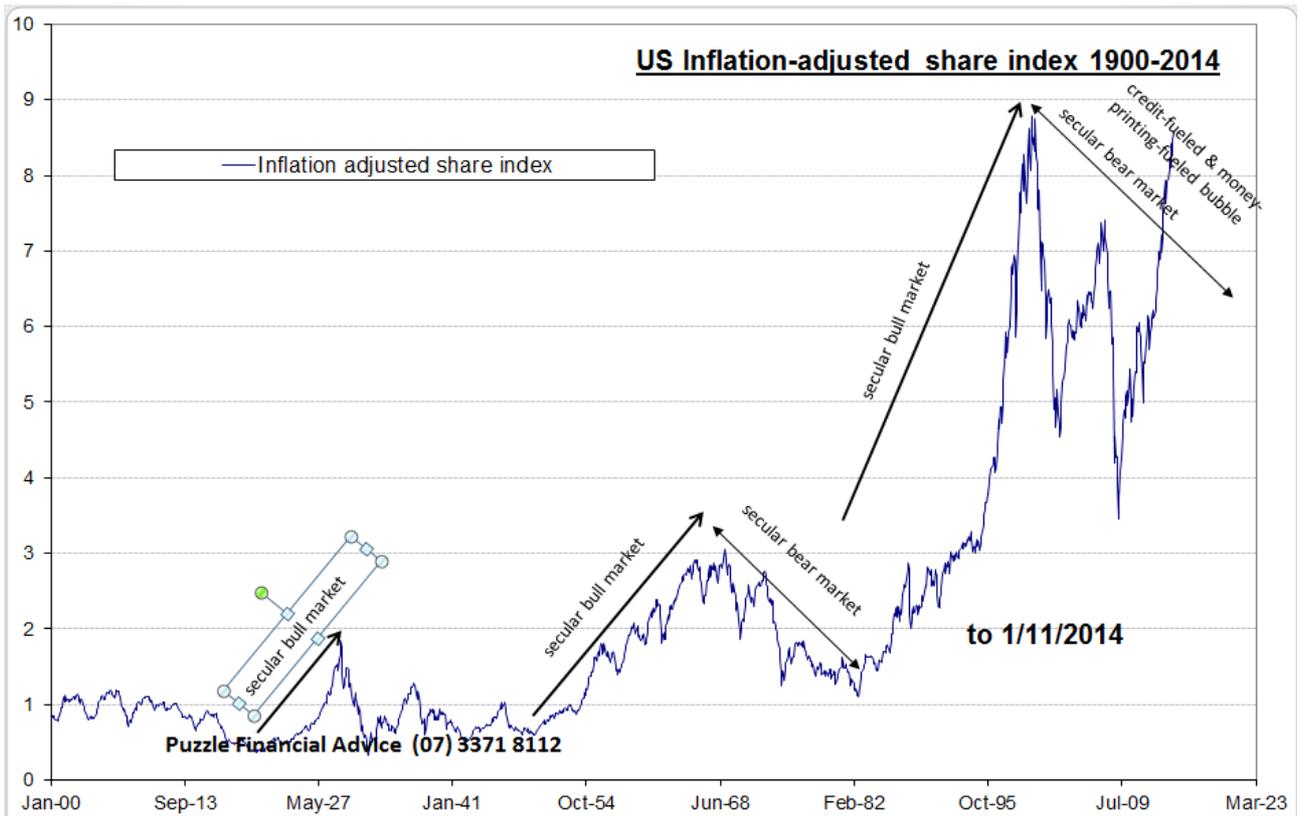
- The Asian secular bull market has begun a new up-ward phase - and has a long way to go (in my view).
 - The Asian secular bull market started in 2003 by my assessment. Just keep in mind, that the long-term average duration of a secular bull market (if you look at the 200-year US data attached) is about 20 years making 2023, the first approximation of the date of the end of the current Asian secular bull market. This is a key factor in why Asian shares have an important role to play in our portfolios for years to come.
 - By contrast:
 - the last US secular bull market started in 1982 - and completed in 2000.
 - the last Australian secular bull market started in 1982 - and the attached paper argues that it finished in 2007. This last Aussie secular bull market was very long bull market by historical standards at 25-years (which is much longer than the average US secular bull market).
- The key reason you need to understand secular market trends is because (if you look at the 200-year US history) included in my attached paper, is that:
 - in a secular up-trend, you tend to get well above long-term average returns.
 - in a secular down-trend, you tend to get well below long-term average returns.

Note: Secular cycles/trends also go by other terms (also discussed in this paper).

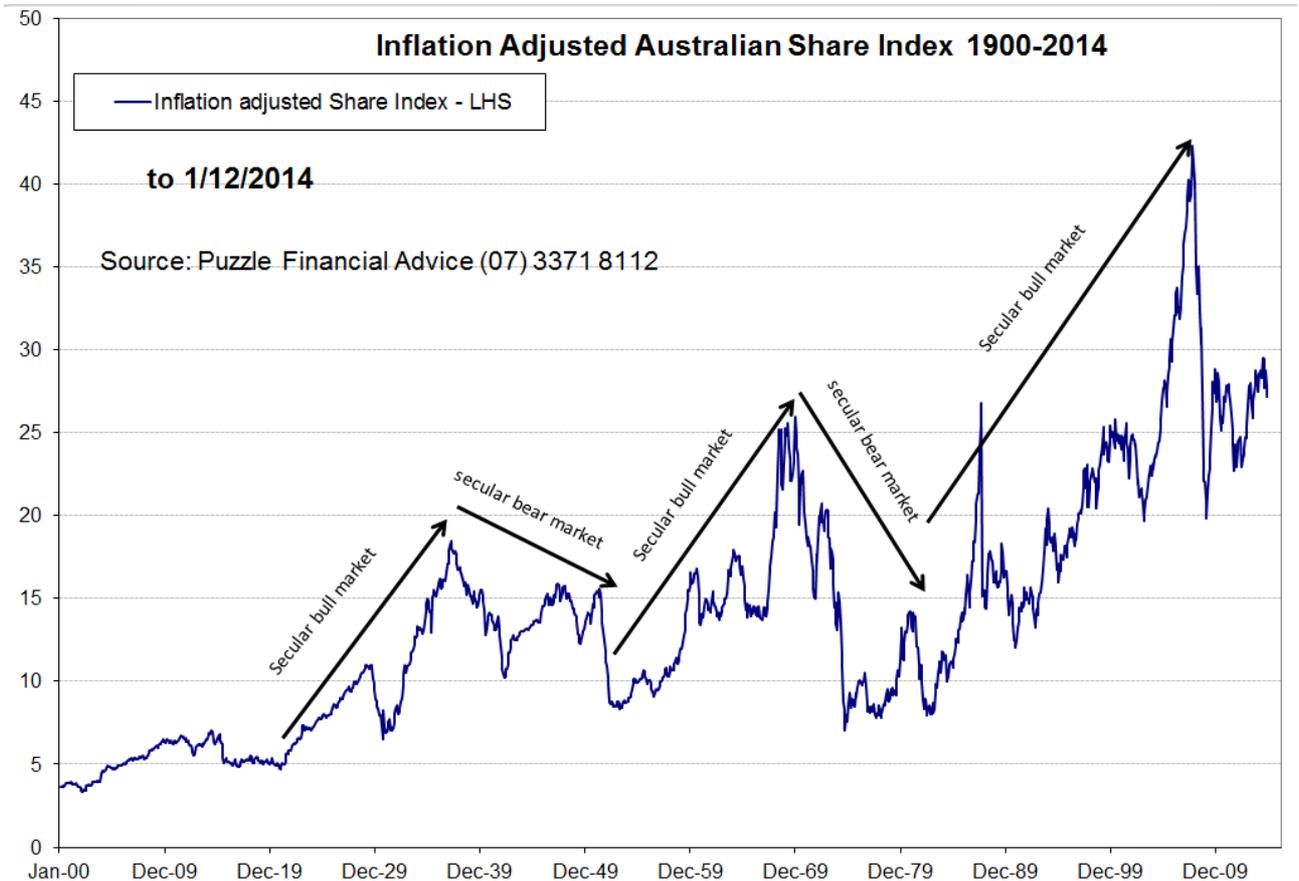
Let me show you some examples.



The Indian share market gives us a good example, of cyclical bull & bear markets within a secular bull market.



With a 100-year chart, I will just illustrate the long-trends (the secular trends). Cyclical trends subdivide the secular trends.



Before I go on to a more detailed discussion, let me give you some references for you to read. I think it is always useful to get different points of view, to test your own views.

Secular & Cyclical markets have long been discussed in financial markets – sometimes, using other terms.

- Elliott Wave International for example, use standard Elliott Wave analysis to label secular & cyclical trends.
- Some talk in terms of Kondratieff cycles, which broadly relate to secular trends.
- Warren Buffet has his own way of characterising these trends.

References for your background reading.

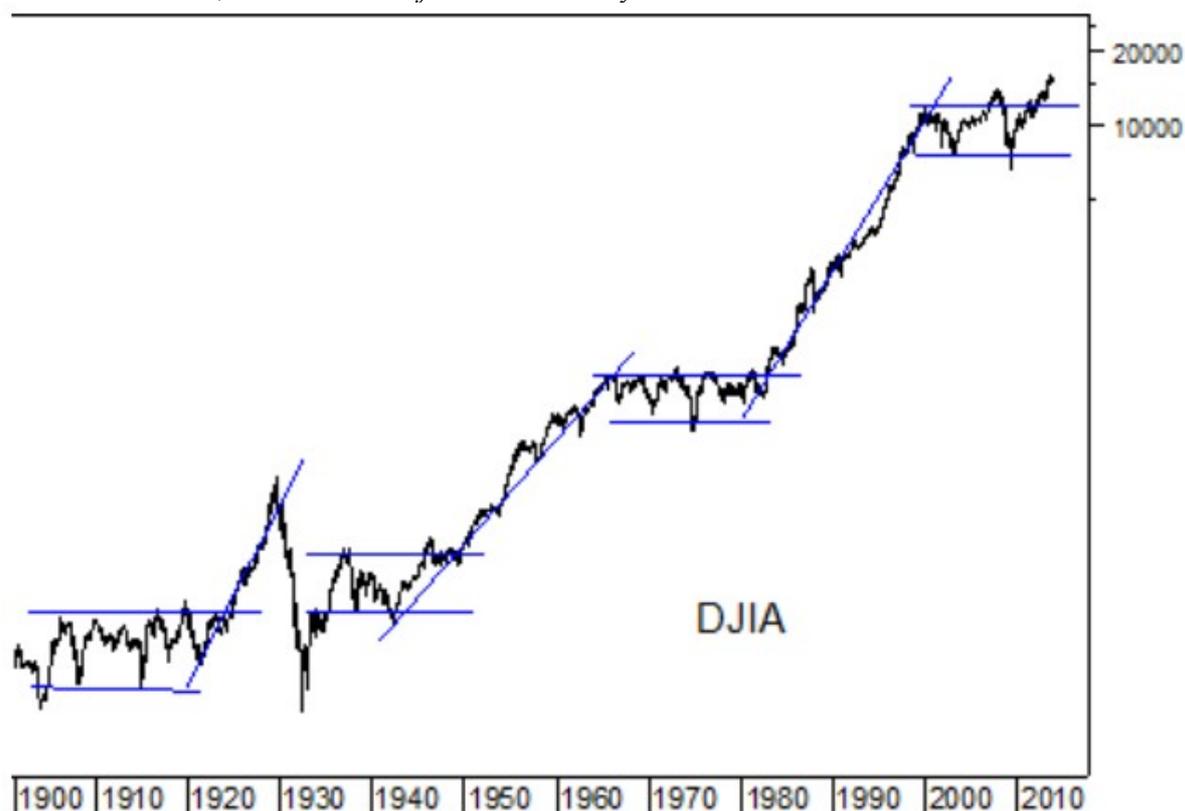
http://en.wikipedia.org/wiki/Stock_market_cycles#Longer_term_cycles:_Cyclical.2C_Secular_and_Kondratiev

<http://www.crestmontresearch.com/stock-market/#20-secular-stock-market-cycles>

<http://www.investopedia.com/terms/s/secularmarket.asp>

<http://www.forbes.com/sites/sharding/2013/11/15/why-its-still-only-a-cyclical-bull-market-within-the-long-term-secular-bear/>

“In 1999 Warren Buffett famously warned that “The next 17 years will be quite unlike the last 17 years. It might not look much better than the dismal 1965-1982 period.” He was referring to the market’s history of cycling between long-term ‘secular’ bull and ‘secular’ bear markets, as it has done for at least 113 years.



So far, Buffett has been right that the 17 years beginning in 2000 would be more like the period of 1965-82 than the 17 years of 1982-2000.

Here are a few of many reasons to believe he will continue to be right, that the cycle will not end until the 17 problem years he envisioned are up in 2017:

- *By most measurements, like Tobin’s Q, Nobel Laureate Robert Shiller’s CAPE ratio, and Warren Buffett’s favorite valuation method (the ratio of total market capitalization to annual GDP), the market has reached substantially overbought and overvalued levels again.*
- *Then there is investor sentiment. Retail investors have fallen back in love with the stock market to a significant degree. According to the Investment Company Institute,*

as is typical in the cycles, public investors, devastated by the 2007-2009 bear market, pulled money out of the market through the first three years of the new bull market that began in 2009. But they have been pouring money back into equity funds at an increasing pace since mid-2012, reaching a near record \$92 billion in the first half of this year, (even as data shows institutional investors have been cutting back their exposure).”

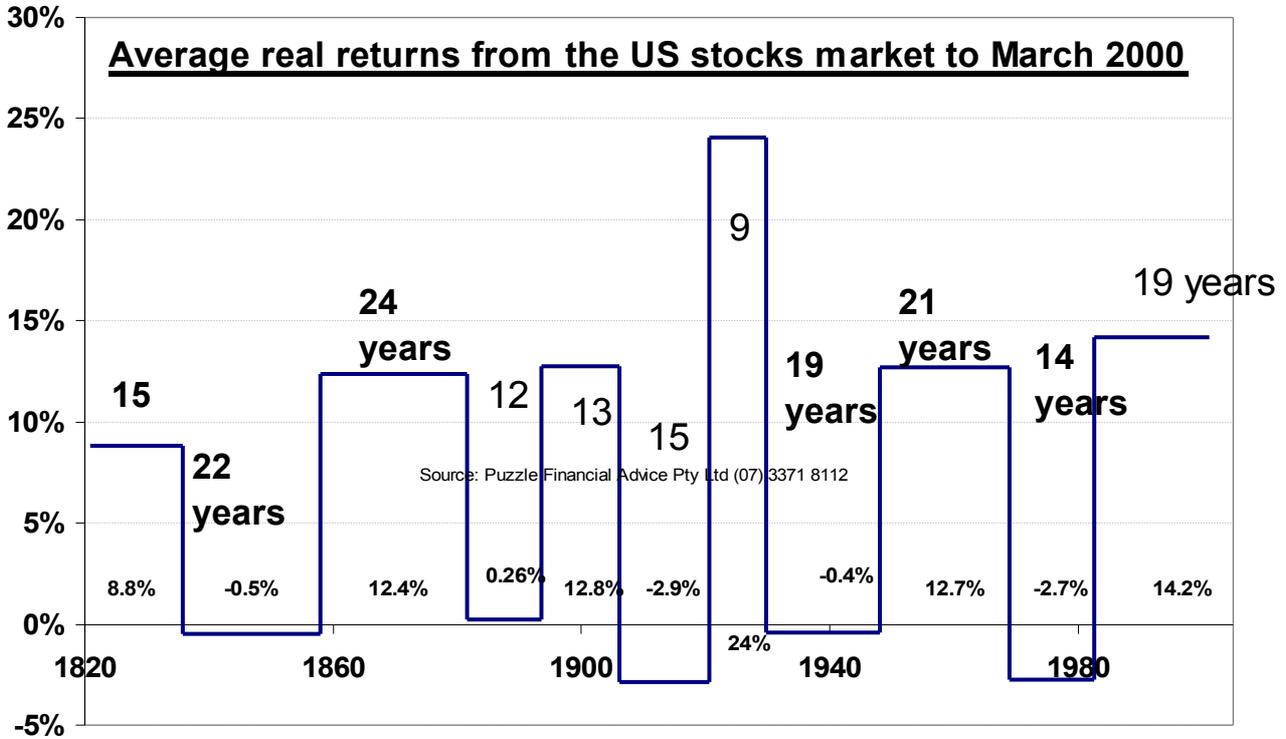
I think this next reference is useful, because it argues the case for why the US secular bear market commencing in 2000, is still in place despite the recent higher peaks (in nominal terms) that we saw in 2000. http://www.jlfmi.com/archives_2014_05.html He argues a number of points (including evidence) including that:

- It is not unprecedented that new market highs have occurred during a secular bear trend.
- 1982-2000 Excesses Yet to be Repaired
- Secular bear not long enough yet. *“Historically, however, the duration of secular bear markets have been of the same general order of magnitude as the preceding bull market.”*
- This secular bear market has not yet fallen to the levels a secular bear market typically ends in (on a price trend basis).
- US share market valuations are still extreme – and have not returned to the valuation levels typically seen at the end of a secular bear.
- Investor behaviour has not yet been consistent with a secular bear market ending.

Needless to say, I agree with his assessment.

Puzzle discussion of cyclical & secular trends.

First, why is it important whether or not Australian shares are in a secular bear market? It is crucially important because long-term investment history shows that during secular bear markets (which tend to last on average about 15 years - see below), the average real return tends to be very low or negative. Long-term buy & hold investors do extremely poorly during secular bear markets.

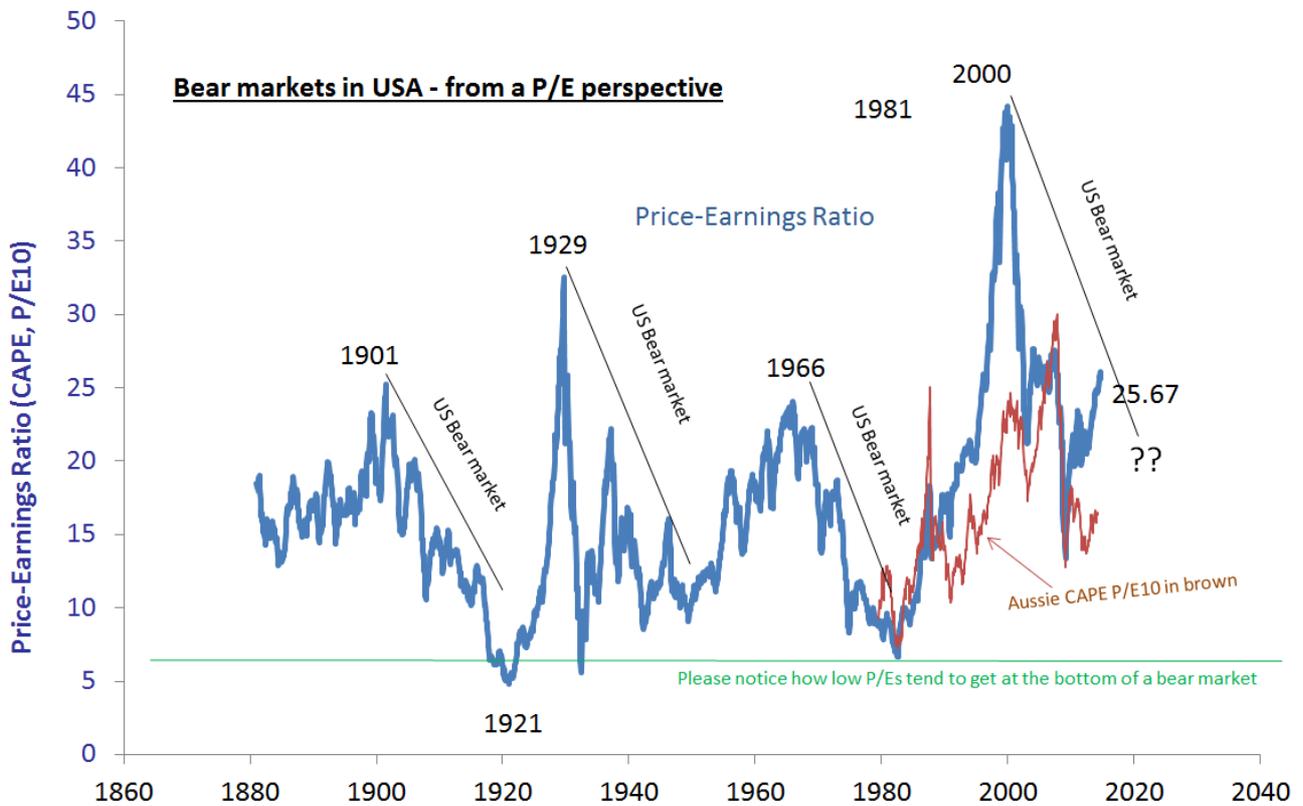


Just ask Japanese share investors who invested during 1989 – since which time, Japanese share investors have made negative returns on average. That said, I believe that Japan probably commenced a secular bull market November 2012, after nearly 23 years of bear market.



So how we define a secular bear market? I think the best definition of a secular bear market (one that David Fuller subscribes to) is a decade plus period of declining Price/Earning Ratios. And at the risk of stating the “obvious”, during a period of declining P/E ratios, it is very difficult for the share market to reach new highs, even if corporate profits are rising.

CAPE Price E10 Ratio - from Professor Robert Shiller



Within that secular bear market, the US commenced a cyclical bull market in March 2009 and is still in that cyclical bull market. As cyclical bull markets go, the US cyclical bull market is now getting very old, and valuations are getting to levels reached only a few times in US history. While we do not yet know when that cyclical bull market will end, it “clearly” must be approaching an end (much closer to the end than the beginning.)

So where is Australia, in terms of secular and cyclical trends?

From the third chart in this paper (where both Australian and US cyclically-adjusted P/Es are shown), while we do not have good quality Australian data going back as far as we have quality USA data, one thing is clear. **Australian share market cycles have historically tracked on a somewhat similar path to the US share market over the last century, because what was happening with the USA has typically been a very large influence on Australia.**

Yes, we can see some differences as well.

- The Australian crash in 1987, because the Australian market became significantly more over-valued than the US share market by October 1987.
- The US crash following 2000, was much greater than Australian share market because broad US valuations had become far more extreme in 2000. This also reflects different sector mixes between USA and Australia, with the US having far more technology companies and more telephone companies, while the Australian share market has far more (as a percentage) of resource companies and financial companies (mainly banks).
- In 2008-2009, Australia had a bigger crash than the USA because in 2007, Australia's valuation on broad averages, had become more extreme than the broad US share market.

So one of the things you might be starting to get a sense of, is one sector (eg in Australia) may be in a secular bull market while another sector may be in a secular bear market. And clearly on broad averages, one country may be in a secular bull market while another country is in a secular bear market – just compare Japan with USA during the 1990s, to see an example.

I believe that Australia, almost certainly is in a secular bear market, that commenced in 2007. And for example, this clearly is the interpretation of the situation by Elliott Wave International. (Just as Warren Buffett shares the view that US commenced a secular bear market commencing in 2000 – see the Forbes Magazine article further above. EWI also believe the USA commenced a secular bear market in 2000).

- The Secular bull market for Australia, from 1982-2007 (25 years) is long as secular bull markets go – a fair bit longer than average. This would be a pointer to at least have us asking whether the secular bull market was over at that point.
- The cyclically adjusted P/E ratio for broad Australian shares rose to a historically high 30 in 2007. While the long-term Australian data is not long enough to see how often that has happened in Australia in the past, we can see in the USA, this level of cyclically-adjusted P/E has only occurred twice since 1900 (I.e in 1929 and in 2000). You will notice from the cyclically adjust P/E chart that after historic peaks, almost always this is followed by a long period of declining P/Es
- Therefore, these 2 observations together make it highly probable that Australia completed its very long secular bull market in 2007.
- Note:
 - When a 25-year old secular bull market ends, it should be expected that the broad community will not recognise the new reality of this market for quite some time. This is why the broad Australian community have largely not come to recognise that the game changed for Australian shares in 2007 – and that we should not expect another broad Australian secular bull market to recommence for many years.
 - That said, there are markets in secular bull markets in Asia, which is why we need to be investing in Asia.

What this probably means in my view? The interpretation of the data.

- In inflation-adjusted terms at least, the ASX200 is unlikely to reach the peak of 2007, within the next 5 years – probably much longer.
- The Australian share market commenced a cyclical bull market (much shorter than a secular

bull market) in 2012. This secular bull market seems to be approaching its end, or may perhaps have already ended. If you read the EWI December Asian Financial Forecast, you will note that this is the question that EWI are now debating internally.

- While I am simply speculating at this point about the end of the cyclical bull market in Australia, at the very least:-
 - If we believe that the secular bull market for Australia ceased in 2007, history tells us that it is highly unlikely that this cyclical bull market will exceed the peak in 2007, at least in inflation-adjusted terms.
 - We should be looking for signs of this cyclical bull market topping.
- I suspect that the Australian economy is heading into recession over the next 12-18 months – and recessions tend to take share markets lower – look to the 1990 recession as an example. The share market tends to try to pre-empt recessions, and thus lead the economy down. If I am correct on this, this is another reason for expecting the broad Australian share market to commence a cyclical bear market at some point – maybe over coming months, if this has not already commenced.