Walter Deemer's

MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

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SECULAR VALUATION CONTRACTIONS

Fullermoney's David Fuller, whom I first met at the Conference On Technical Analysis in Cambridge, England in September, 1974 and who is still going strong in London, coined a marvelous phrase to describe the current very long-term corrective process that is taking place in the stock market: "Secular Valuation Contraction". I think it's a much better definition than the much more widely-used "secular bear market".

I've seen a number of comments recently pertaining to the current secular valuation contraction, which presents me with an opportunity to review it and put it into perspective.

First, an update from Mr. Fuller himself: "The previous [secular valuation contraction] commenced in 1966. I mark the end [of it] as occurring in 2Q 1982, when the S&P 500 index yield reached its high point at 6.21%."

He added a vitally important point: "Secular valuation cycles do not end with the indices at historic lows. [My eEmphasis added throughout.] In fact, they are well above their index trough for the cycle because GDP growth, earnings increases and rising dividends are responsible for much improved valuations."

Bob Farrell then observed: "There is a difference between a panic low and a sold out low that is best observed in a secular or long term bear market. Most often, the panic low is the first leg or 'A' wave decline which at its contrary extreme leads to a 'B' wave recovery that is a temporary retracement to be followed by a more extended 'C'wave down to desultory lows, undervaluation and disinterest. Usually, the price low occurs at the end of the 'A' wave and the valuation low much later at the end of the 'C' wave. It is much harder to recognize the right time to be contrary at the 'C' wave valuation lows than at the panic 'A' wave price lows because the reasons for the crowd's bearishness can be valid for a long time.

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"This is a long introduction to present circumstances", he went on. "We are in a secular bear that has persisted for 12 years and taken us into an extended 'C' wave. The valuation low still could be years ahead even if price stays in a series of cyclical trading swings. In the 1930s secular bear, the price low was in 1932, but the valuation lows occurred 10 to 15 years later in the 1940s. In the 1968-82 secular bear, the price low was in 1974 but the valuation low occurred eight-years later even though prices did not approach the 1974 lows. Valuation lows at the end of a "C" wave are made when the majority gives up on equities as an investment and the extremes reached are the opposite of the valuation extremes at the top."

That last point is critical, given that the current "secular valuation contraction" process has been at work since 2000. To cite an unsourced table that a financial adviser friend recently sent me, in January 2000 the S&P 500, at 1469, sold at 30.6 times earnings. By March of this year, it was down to 14.2 times earnings. In 2000, meanwhile, it yielded 1.16%, but thanks to a 70% increase in dividends since then it now yields 2.06%.

Critically, though, mean or "normal" valuations are not the same as trough valuations, as I discussed at some length in the "Reversion To The Mean" section of my book (which I have given myself permission to reprint):

"The mean is nothing more than an average, a constantly changing number that reflects a mathematical point where there are an equal number of data points above and below the calculated number."

"Many analysts say that the market ultimately 'reverts to the mean' as if the mean had some kind of magnetic attraction; where the market should be. But the market hardly ever stops at the mean. It oscillates between extremes of fear on the downside and greed on the upside, and it rarely stops right at the mean. The market always swings like a pendulum from periods of pessimism to periods of optimism, and it is always prone to extremes at both ends. Investors should be worried much more about how far the pendulum will swing than where the mean is.

"Let's say, using round numbers, that the P/E ratio ranges between 5 and 25. So the mean is 15. So let's say that the P/E ratio peaked at 25 but is now 15. Should we be happy? No. If the P/E ratio stopped when it got to 15, then the mean wouldn't be 15. The extremes would be 25 and 15, and the mean would be 20. For the mean to be 15, there have to be as many data points below the mean as above it. The scary thing about this is that analysts are always reassuring people when the market has regressed or returned to the mean. But the mean is meaningless in assessing stock prices.

"This is very important to consider today. During the 1990s, valuations were above average, and returns were outsized. During 2000 to 2010, valuations have been correcting toward more normal rates of return but have not yet reached the other extreme. People say, 'Aha! We have regressed to the mean.' And what they think they are saying is that valuations are now reasonable, and the implication is that they could stay that way. These people couldn't be more wrong.

"At this particular time, having gone through a period of extreme optimism in the 1990s, the issue is, How far is the pendulum likely to swing the other way? History suggests that it is likely to swing, eventually, to a period of pessimism and that since the 2000–2007 period, the general public investor, as opposed to hedge fund traders, high-frequency computers, and so on, has become less and less enchanted with stocks. Even though the market has been doing reasonably well since 2009, <u>the numbers suggest that the equal but opposite extreme has yet to be seen.</u>

"The mean, in other words, is not the magic stopping place that Wall Street strategists would have you think it is."

The foregoing all leads us to three very important takeaways:

1) In a secular valuation contraction, the price low is made many years before the valuation low.

2) Secular valuation contractions do not end when valuation parameters first reach their mean, or "normal" levels, but continue until the parameters reach extreme undervaluation levels similar but opposite to the extreme overvaluation levels at the peak.

3) The final phase of a secular valuation contraction is a long, drawn-out affair that can take a very long time to be completed. And, to paraphrase Bob Farrell, when it finally is stocks will sell at historically cheap levels but nobody will care.

That last point is critical; it suggests the public's disenchantment with stocks is a secular, rather than cyclical, phenomenon. If so, it means they won't come storming back into stocks in the relatively near future but, rather, will stay on the sidelines as their concerns are reinforced with every new Facebook, Knight *et al* episode. (This also suggests some of the more popular sentiment indicators are likely to develop new parameters reflecting the generally-more bearish tone; we'll discuss this in a future commentary.)

And, of course, the fact that we're in the midst of a secular valuation contraction during Year Four of the Four-Year Cycle increases, rather than decreases, long-term risks.

The Market Now. We are in Year Four of the Four-Year Cycle, when bad things -- and, sometimes, very bad things -- traditionally occur, and the fact that we are in the midst of a secular valuation contraction increases the long-term risks even further. The uptrend of the past few years is giving way only very, very reluctantly, though, as is almost always the case with uptrends of this magnitude, and the fact that our economy is relatively stronger than other global economies is undoubtedly a major factor in this. Lowry's, though, is very unhappy with the current market internals, and a close below 1394 would generate a short-term reversal which would have especially negative implications if the financial sector turns relatively weak in the process. A close below 1266, meanwhile, would have at least intermediate-term consequences. Whatever may or may not happen over the short-term, though, long-term risks are unacceptably high.

The "Farrell Sentiment Indicator". Doug Kass wrote about something he called the "Bob Farrell Sentiment Indicator" this week. This, in turn, led to a flurry of conversation all over the Internet. You might be interested to know, then, that Mr. Farrell had nothing at all to do with that "Farrell Sentiment Indicator".

Fidelity Sector Funds. 76% positive vs. 79%. Switching program holdings: #3 Biotechnology, #5 Consumer Finance and #11 Banking.

-- Walter Deemer (in Brevard, NC)

FIDELITY	PRICES (in cents)					DTR STRENGTH RATINGS				
SECTOR FUND	Aug 8	Aug 1	Jul 25	Jul 18	R/C	Aug 1	Aug 1	Jul 25	Jul 18	Jul 11
Multimedia	5381	5166	5022	5122	10	112	102	80	110	81
Telecommun	5039	5007	4704	4904	-10	92	103	51	99	86
Biotech	10515	10457	10578	10913	-50	87	136	165	198	164
Consumer Stpls	8108	8043	7787	7981	5	84	79	55	89	70
Consumer Finance	1365	1337	1318	1342	-11	74	85	81	99	79
Wireless	791	768	726	742	19	65	47	-3	29	11
Energy Serv	6771	6593	6191	6251	8	62	54	-7	-4	-52
Chemicals	11287	10982	10750	11019	-1	54	55	45	78	55
Natural Gas	3161	3120	3013	3033	0	54	54	23	37	0
Pharmaceutical	1501	1493	1465	1510	-15	52	67	54	93	66
Banking	1907	1870	1854	1909	-12	50	62	75	95	74
Computers	6399	6151	5910	6065	18	48	30	-11	21	-9
Utilities	5742	5772	5668	5748	-11	47	58	40	72	64
Energy	5094	4946	4736	4850	8	47	39	0	29	-17
Insurance	4935	4783	4680	4828	12	39	28	7	52	33
* * S&P 500	140222	137532	137278	137278	-1	38	39	44	49	25
Constr/Hous'g	4223	4096	4075	4172	-6	38	45	44	71	70
Financial	5757	5647	5550	5686	-12	36	49	40	70	35
IT Services	2397	2287	2236	2333	22	35	13	-15	32	-8
Technology	9989	9618	9358	9555	9	33	23	-10	16	-12
Healthcare	13549	13339	13224	13741	-13	30	43	45	90	73
Materials	6810	6580	6414	6570	8	29	21	6	41	19
Broker/Invest	4538	4388	4288	4420	5	29	23	12	49	29
Nat Resource	3168	3062	2932	2997	14	29	15	-23	4	-36
Software	8419	8110	8000	8216	6	27	21	3	39	-23
Retailing	6074	5938	5874	5995	-9	27	36	19	50	36
Consumer Discr	2677	2603	2566	2646	-3	26	28	12	47	31
Industrials	2417	2346	2271	2333	7	25	18	-8	18	-13
Indust Equip	3492	3379	3295	3371	9	21	12	-3	17	-16
Environmental	1574	1530	1483	1535	13	20	7	-23	13	-16
Medical Equip	2740	2691	2680	2777	-9	4	13	20	58	53
** Emerging Mkts	4037	3919	3760	3881	3	4	1	-32	6	-3
* * T Bills	1985	1985	1984	1984	0	0	0	0	0	0
Defense/Aero	8169	7936	7901	8110	8	-7	-15	-10	18	-11
Electronics	4773	4670	4450	4463	-19	-12	7	-51	-36	-57
Transport'n	5136	5061	4980	5251	-14	-19	-5	-11	43	45
Airlines	3704	3633	3652	3832	-5	-22	-17	-9	39	42
Comm Equip	2138	2029	1959	1978	28	-29	-57	-103	-81	-106
Medical Del	5884	5682	5715	6118	13	-34	-47	-38	44	37
Automotive	3303	3138	3019	3232	21	-36	-57	-91	-29	-42
Leisure	9785	9520	9673	10297	-2	-74	-73	-68	-9	-11
Gold	3588	3457	3404	3339	27	-93	-120	-131	-123	-98