January 2013

Are We at the End of the Secular Bear Market for Stocks?

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An important question that's worth asking now is whether the secular bear market for stocks is ending. At 13 years, it is getting long in the tooth. The S&P 500® Index has reached a new all-time high on a total return basis and is just about 75 points shy of its October 2007 high of 1,576 on a price-only basis.

Many—if not most—investors are probably unprepared for a turn from a secular bear to a secular bull market, including those who have favored bonds since 2007 and especially the pension funds that have de-risked in recent years.

While I have my doubts that such a turn is imminent—we may be getting yet another short-term cyclical peak—the possible end of this frustrating secular bear market is one of the more contrarian ideas, and therefore worth considering.

Identifying secular bear markets

I define a secular bear market as a prolonged period spanning several business cycles of below-average—although not necessarily negative—nominal returns, an outright decline in real (inflation-adjusted) returns, and a sustained compression in price-to-earnings (P/E) ratios. By that definition, we've been in a secular bear market since 2000. Three previous secular bear markets in the U.S. were 1902–1921, 1929–1942, and 1968–1982 (see Exhibit 1, page 2).

Looking as far back as we have stock market returns, using data since 1871 from Robert Shiller's book *Irrational Exuberance* spliced on to official index data beginning in the 1920s, we come up with the following statistics (all returns are annualized compound returns). From January 1871 through December 2012, the compound annual nominal total return for the S&P 500 and its pre-1920s proxy has been 8.8%, and the inflation-adjusted real return has been 6.5%. The average P/E ratio was 15.6 times four-quarter trailing reported earnings.

The first secular bear market spanned more than 19 years, from 1902 to 1921. During that time, the nominal total return was 3.7%, and the real return was –0.4%. The P/E fell from 14.8x to 14.0x.

After that came the relatively short but sweet secular bull market of the Roaring Twenties. During this eight-year period, the S&P 500 gained 27.5% in nominal terms and 27.8% in real terms. The P/E ratio climbed from 14.0x to 20.2x.

The stock market bubble of the late 1920s—along with many other factors—ushered in the Great Depression of the 1930s, and a nearly 13-year secular bear market persisted from 1929 until 1942. The S&P 500's nominal return was –5.2% and its real return was –4.6%. The P/E ratio fell from 20.2x to 7.7x. A lack of demand was the hallmark of this period, and the resulting deflation explains why the real return was not lower than the nominal return.

KEY TAKEAWAYS

- Analyzing long-term historical trends in both prices and earnings can help to identify the long-term cycles of secular bull and bear markets.
- Since 2000, equities have been in a secular bear market, exhibiting lower lows, lower highs, and sustained declines in valuations and inflation-adjusted returns.
- From a technical perspective, there is evidence that the downtrends might be breaking and that maybe the worst for the stock market is over.
- If so, investors may want to avoid positioning their portfolios too defensively to take advantage of the potential upside from equities.

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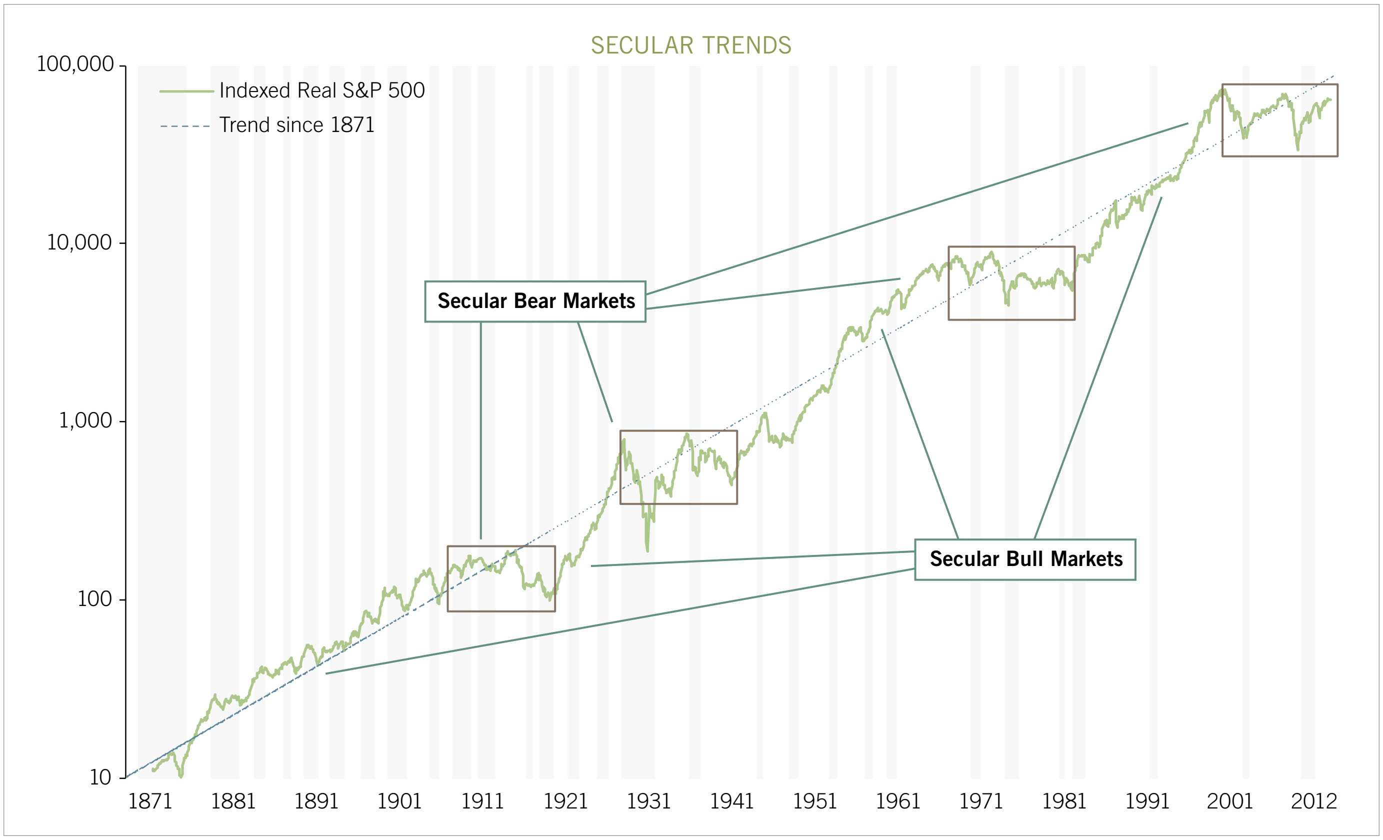
EXHIBIT 1: In addition to the secular bear market since 2000, there have been three others: 1902–1921, 1929–1942, and 1968–1982.



Monthly data since 1871. Source: Haver Analytics, Robert Shiller, Fidelity Investments through December 2012.

The next secular bull market extended more than 26 years, from 1942 to 1968, when the U.S. was the envy of the world, and war-ravaged Europe and Japan needed American products to rebuild. During this period, the stock market's nominal return was 15.1% and the real return was 11.7%. The market's P/E expanded from 7.7x to 18.4x.

Then came another secular bear market during the stagflationary 1970s—a period of concurrent low growth and high inflation. From the 1968 peak of the small-cap bubble to the 1982 trough of the double-dip recession that resulted from then–Federal Reserve Chairman Paul Volcker's efforts to fight inflation, the S&P 500 returned 4.3% in nominal terms and –3.1% in real terms. The P/E ratio fell from 18.4x to 7.7x.

During the disinflationary and multiple-expanding secular bull market of the 1980s and 1990s, the S&P 500 returned 19.1% in nominal terms and 15.4% in real terms. Over that 18-year period, the stock market's P/E ratio ballooned from 7.7x to 28.6x based on operating earnings—or an even more extreme 48x based on reported earnings.

Since the bubble burst in 2000, stocks have been languishing in a secular bear market, during which the S&P 500 has returned only 1.4% in nominal terms and –1.0% in real terms. The P/E ratio fell from 28.6x to 9.6x at the March 2009 low and has now climbed back to 15.8x.

Across these cycles, the average secular bull market lasted 21.2 years and produced a total return of 17.2% in nominal terms and 15.9% in real terms. The market's P/E more or less doubled, from 10.1x at the start to 20.5x at the end of the average secular bull. The average secular bear market lasted 14.5 years, with a nominal total return of 1.0% and a real return of –2.3%. The P/E ratio compressed by an average of nine points, from 20.5x at the start to 11.3x at the end of the average secular bear.

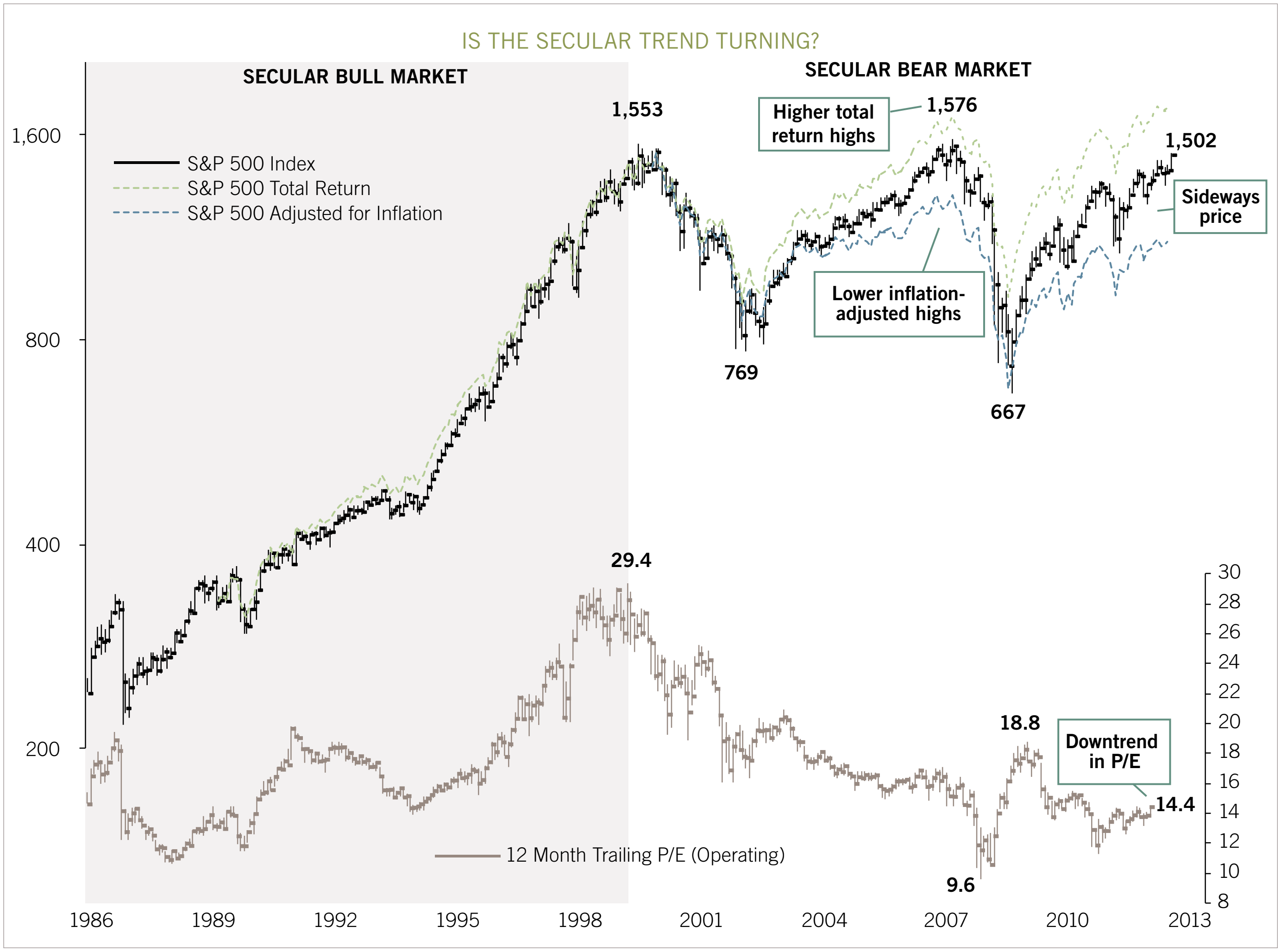
Relative to these historical averages, the past 13 years fits the profile of a secular bear market perfectly.

Thirteen years later...

Is this frustrating, prolonged period of low returns finally ending? Could we be ready to embark on a new sustained long-term cycle of above-average returns—a secular bull market?

Let's consider some key technical questions. Is the S&P 500 still making lower highs and lower lows? Are nominal and real total return and price-only indices still on downtrends? What about the downtrend in P/E multiples?

EXHIBIT 2: Technical signs suggest that the 13-year secular bear market may be coming to an end.



Monthly data since 1986. Source: Fidelity Investments through December 2012.

Some answers suggest the secular bear market is still in place, but other answers hint that it's over, and that's promising (see Exhibit 2, above).

In terms of valuation, the P/E ratio for the S&P 500 Index was 29 times trailing operating earnings in 2000 and briefly dipped below 10x in March 2009. Today, it's 14.4x, which is well off that low. So while we can argue that the P/E multiple is no longer making lower lows, we cannot yet say that it is making higher highs.

As for price returns, are there any signs of a break for the better in the trend? So far, the answer is no, but the outlook may be promising. In nominal price terms, the S&P 500 has gone nowhere for 12 years, peaking at 1,553 in August 2000, troughing at 769 in October 2002, peaking at 1,576 in October 2007, bottoming at 667 in March 2009, and now reaching a cycle high of 1,502 on January 25. Until the S&P 500 surpasses 1,576, there is really nothing to say.

In real price terms, the downtrend since 2000 has been unmistakable. With each successive bull and bear market cycle, the S&P 500 adjusted for inflation has put up a series of clearly defined lower highs and lower lows, losing 0.5% per annum over the entire span. But now the index has reached the point where any further gains on a price basis will break the downtrend that has been in place since 2000. So it seems that we are getting close to a turn.

As for total returns, the picture is more promising. In terms of real total returns, though the S&P 500 has not made new highs, it has convincingly broken through the downward trend running across the 2000 and 2007 peaks, which bodes well.

In terms of nominal total returns, the story is even more promising. The S&P 500 Total Return Index peaked at 2,104 in 2000, fell to 1,163 in September 2002, rose to a new high of 2,424 in October 2007, fell again to 1,189 in 2009, and reached a new all-time high of 2,504 on January 25.

Conclusion

All in all, from a technical perspective there is some reason for optimism that we are getting close to the end of this frustrating period of market history. However, one thing gives me pause: each secular bear market I studied included at least three cyclical bear markets with declines of 20% or more. So far in this secular bear market, there have been only two: 2000–2002 and 2007–2009.

Will we get a third? That is unknowable, of course, but it wouldn't surprise me. There are certainly plenty of issues that could cause stocks to struggle, from the U.S. fiscal situation to problems in Europe and China. Then again, those are "known unknowns," and perhaps it is only the "unknown unknowns" that can move markets these days. So we need to stay open to the possibility of another cyclical downturn that would run into late 2013 or 2014, although—as the saying goes—history never repeats itself, but it often rhymes. Maybe things will turn out differently this time.

In any case, while it is impossible to predict how markets will behave in the years ahead, this study of market history seems to suggest that maybe the worst is over. If so, it would be important for investors to look closely at their portfolios to make sure they are not too defensively positioned and that their investment allocations are in line with their long-term goals.

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Reference
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