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Real Money

Are We In Another Bull Market Or Is It Just A Bear Market Rally?

The most important question that investors need to ask themselves today is whether the seeming resurgence in the stock market is real or if it is a trap for the unwitting.   I know many people are ready to climb aboard the train but a word of caution is necessary: central to the theme of a Bull Market is a growing economy. On a sustained basis, rising stock prices require what is called “rising price earnings ratios.”

Given the fairly moribund state of the U.S. and global economies, it is hard to imagine that we are in a period where people will be willing to pay more for the privilege of owning stocks. Historically speaking, it is likely that we are in a Bear Market rally, which is a time period when the market moves up strongly - often well over 20% - only to later resume its downward march.

For people tired of earning almost nothing in savings and money market accounts, it is tempting to think and feel that we are at the beginning of a new Bull Market. Let's look at some basic economic facts: Oil prices are down but not down very much and are still high; Consumers are spending, but only at static levels; Business investment in equipment and technology has not yet reignited to the point where a sustained increase in factory utilization looks likely.

On the other hand, low interest rates have kept the housing market strong. Refinancing of home mortgages is estimated to inject about $30 billion into the economy in the next quarter and new housing starts are also up. The biggest issue, though, is employment. The U.S. economy continues to lose 80,000 jobs a month. The Administration's recent promise to create between one and two million jobs by the next election seems like a fantasy.

A telling sign for stock market forecasters is whether corporate insiders are buying or selling their own company's stock. This past May, insider selling hit a 2-year high as business executives sought to cash in their stock. This is not a good sign! The bottom line is that corporate profits are going to have to turn up in order to justify people putting money into the stock market.

The price earnings ratio I referred to above is the most common indicator looked at to decide whether stocks are too expensive, or conversely, a good deal. Currently, the stock market as a whole is estimated to be selling at between 25 and 32 times earnings. This compares unfavorably with the historical average, which is around 15. In other words, the stock market still looks about twice as expensive as it has been, on average, over the last 70 years.

Low interest rates often help convince people to move money into stocks, as it seems like a stock paying a dividend of 3% is better than a bond paying about the same rate because of the stock's potential for growth. This seems logical but, remember that downside protection is the foremost strategic objective of astute investors in periods of sideways or downward moving stock markets.

Some investors are worried that contingent pension liabilities and the cost of companies issuing stock options to their executives make stocks even more expensive right now. For a new Bull Market to exist, we must grow our way out of these kinds of economic problems. If lower federal tax rates and credits for the wealthy actually create growth on a consistent basis, the results of next year's elections are not going to be hard to predict.

If the economy continues to exhibit lackluster strength, especially in terms of business spending, then even the low interest rates being promulgated by the Federal Reserve Bank will not help people plunk down money for stock. In the event that we do not experience a high degree of growth, the borrowing needs of the Federal Government, which is running approximately 400 billion dollars per year, will create further economic dislocation.

The US dollar could decline precipitously or deflation could undermine the confidence of stocks and bonds investors alike.

Some very intelligent people have made a good case that the stock market bubble of the late 1990's has been transferred over to real estate and that it, along with bonds, will eventually experience a bust. The Federal Reserve, by setting interest rates low, provided the liquidity necessary for the extraordinary prices paid for stocks up through 2000. Because of the fears that emerged after September 11th , and in order to continuously encourage American consumers to spend, interest rates have been kept low. The hope has been, and it continues to be almost pure speculation, that we will grow our way out of the asset bubbles created by all the extra cash sloshing around the system. This is the logic behind the latest round of cuts in taxes and interest rates.

The Fed has come out and said in public that it won't raise interest rates because it wants people to spend money. Whether consumers spend money on real goods or buy stocks, bonds, or real estate, doesn't really matter. People in high places realize that if people stop spending money, the economy will grind to a slower and slower pace, much like in

Japan, and then people holding assets will get hurt as the high valuation bubbles begin to burst.

It is possible to make money during sideways moving and down markets by trading in and out of stocks. Long-term index and mutual fund investors are likely to be disappointed. Although the stock market has delivered an average return of 10%, it is crucial for investors to remember that very few, in fact, none of the 20 year periods that experience positive returns started with a price earnings ratio anywhere near the level that it is today. Individual investors planning their retirement ought not to depend on a 10% return in stocks, nor even a steady 8% return because of how expensive stocks remain today as compared to historical standards.

Statistically speaking, strong positive gains in stocks never have occurred without rising price earnings ratios, which only occurs when the period of investing starts out with a low ratio. We are currently in a period of high relative PE ratios so it is likely that the next two decades will see declining, as opposed to rising, ratios. If this is true, the long-term trend in overall equities will continue to be downwards for an extended period of time.

There are investment vehicles that strive to obtain positive return no matter what the market does. This requires agility to move between stocks, bonds, and cash in a fairly rapid manner. Remember though, as you shop for an alternative to CDs, not to buy anything without having a clear price point at which you will sell. Protecting your principal by going to cash is not a mark of failure.

This runs counter to the traditional maxims held dear by many who successfully rode through the depression and long bear market of the 1970s. In the end, you need to be comfortable with the amount of funds held in long-term equities. Develop a strategy that is flexible enough to deal with potential political and economic crises as they occur.

Making money in the stock market is a lot harder now and a lot more anxiety provoking than it has been for over half a century. We had some lucky, maybe a bit too lucky, years in the market in the late 1990s. Anyone who expects a repeat of that performance is likely to be disappointed.

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