Still Bullish, but Wondering: What Might Cause the Next Bear Market?

JANUARY 2014

Executive Summary

We remain optimistic about U.S. GDP growth over the next few years, expecting a quarter or two of 5% real GDP growth in 2014; and we think the U.S. economy will pull the global economy and the U.S. and international equity markets to solid performances over the next couple of years. We laid out our arguments supporting these forecasts in two mid-year 2013 white papers ("A Different Sort of Turbulence: Brace Yourself for Rapid GDP Acceleration" and "What About the Fed?"), and we think that the performances of the economy and the markets in the second half of 2013 have so far supported our hypotheses. It does appear as though the fiscal drag is lessening, pent-up demand is helping auto and home sales, credit conditions are loosening, and investment spending is showing signs of life. So we are sticking with our bullish macro view in 2014.

Being bullish does not mean we are complacent. All bull markets end. As we have done throughout this TT series, we are trying to look past the present to assess what might lie a few years down the road. In this piece, we consider the forces that have driven past bear markets, which we sort into four categories:

- Excessive valuation
- Public policy surprises
- Recessions
- Other shocks, especially unexpected inflation

What might cause the next bear market? Stocks are no longer cheap, but we do not think valuation is yet high enough to create a new bear market. Although a recession is not impossible, it is highly unlikely in our view.

If a bear market is to start in 2014 or 2015, we suspect that it will be due to either higher inflation or fear that the Fed will move unexpectedly aggressively to fight the threat of higher inflation. The Fed has clearly stated that they view lower unemployment as a precondition (though not a trigger) for less easy monetary policy. If our above-consensus economic growth forecast becomes reality, then unemployment might drop much more rapidly than consensus expectations. That might be good for many individuals, but it might spook investors, scared that the Fed might be behind the curve. The result might be a nasty correction.

Will that correction become a full fledged bear market? We think not. Some corrections, like the one in the summer of 2011, can be head fakes, unless the fundamentals perform worse than expected. We think that current slack capacity combined with new capacity will keep inflation low even as growth accelerates. We do think that volatility will increase from the current very low level, but that is part of the process of returning to "normal."

We think the new normal might resemble the old normal of the post-war U.S. economy for the next few years, with real GDP growth of 3-3 .5% or more, nominal GDP growth of 5-6%, earnings growth of 7-10%, and equity returns about in line with earnings growth, say 7-12%.

Meet the New Normal, Same as the Old Normal

In June of 2013, we published two mid-year editions of this Turbulent Teens series titled, "A Different Sort of Turbulence: Brace Yourself for Rapid GDP Acceleration," followed soon thereafter by "What About the Fed?" Our primary point, controversial at the time was:

> "After struggling along at around 2% growth for the past few years, by late 2014 we think that the U.S. will start to experience quarters with real GDP growth of 5% or so. Although eventually growth will likely fall back to a more sustainable trend of 3%, we would not be surprised to see above-trend growth persist into 2016 or longer."

We described our case as "fairly straightforward." We thought that fiscal drag would fade as 2014 dawned, and that government spending at all levels might even provide a small GDP boost in 2014. We believed that "increased household wealth, a recovery in house prices, a recovering labor market, and better access to credit should allow consumers to satisfy their pent-up demand for housing, autos, and other consumer goods." We thought that the U.S. energy renaissance would continue, modestly boosting GDP in multiple ways in 2014 and in years to come. (We also suggested that the federal budget could be in balance in fiscal year 2015. That's a long shot, but if it happens, you read it here first.)

In our follow-up piece on Fed policy, we argued that the market and the economy could handle the tapering and eventual ending of quantitative easing (QE), as long as growth accelerated and inflation remained low. We forecasted that the yield on the 10-year Treasury bond would rise to about 3% in mid-2014 (of course it turned out that the 10-year topped 3% in the last week of 2013). We suggested that "increases in interest rates might provide a bit of a headwind for stocks… but even if valuations do not increase from here, we think it is reasonable to expect equity returns over the next couple of years to be about…7-12%."

Although the jury is still out on these calls, the early reads look pretty favorable. Though it was boosted by inventories, third quarter 2013 GDP accelerated to 4.1%. After a lot of drama in 2013, it appears that the federal government will play a quieter and perhaps somewhat positive role in the economy in 2014, thanks to the recent budget deal. Consumer spending appears to be accelerating. Though higher rates did slow the growth of housing sales, sales seem to have picked

up again in the fourth quarter. The equity market continued to rally in the second half of 2013, and though we are not complacent, we remain confident that our mid-year calls will mostly pan out in 2014.

PIMCO memorably coined the phrase “new normal” to describe a possibly prolonged period of slow growth in the wake of the financial crisis. For the last few years, that call seemed prescient, at least as it applied to GDP growth.

But if we are correct, the economy and the markets over the next few years could resemble the old normal of the post-war period, with real GDP growth averaging 3 – 3.5% or so, stocks delivering returns roughly in line with the long-term average of 10%, and bond yields slowly rising.

Of course, an “old normal” environment might require more than one organization to re-think its nomenclature: that doesn’t sound like the “Turbulent Teens.” From the perspective of our clients, the only perspective that truly matters, an old normal environment might be just the ticket: solid returns with less agita. Dull is good. But dull is not great for pontificators. Should we just re-name this series the “Tranquil Teens” and hit the beach? As sunny as that sounds, we are taking a different tack.

Since our optimistic macro view is essentially unchanged from our mid-2013 pieces, we ask a new question: When and why might this bull market end?

After two crashes in less than a decade, clients remain leery of risk and scared of the possibility of another bear market. So in this piece, we will attempt to look past our very optimistic near-term view of the markets and the economy and consider prior bear markets. What caused them? Are there commonalities? And if there are, should we be wary of an approaching bear now or in the near future?

What Has Caused Bear Markets?

Investors courageous enough to have invested in the S&P 500 Index at the low of March 2009 will have about tripled their money by late 2013. After the worst financial and economic crisis since the Great Depression, the equity market has bounced back strong, even if the economy has not (so far). As we wrote in the mid-year 2013 version of this Turbulent Teens series, we think that the U.S. economy will accelerate in 2014, and we think that this bull market still has a way to run.

But even as we maintain an overweight of equities in the portfolios we manage and speak confidently about the future, it is not unreasonable to ask the questions: when and why might this bull run end? And is it likely that it ends sometime soon, say in 2014 or 2015?

No bull market lasts forever, and short, sharp corrections of 5, 10, or even 20% are a normal part of equity market behavior. For the purposes of this piece, we will define a bear market as one in which stocks suffer negative total returns over a period of at least 12 months, with a peak to trough loss of at least 20%. Is such a period likely to start sometime in the next two years?

As a way of thinking about this issue, we offer Figure 1 on the following page, which shows the S&P 500 price level on a log scale with bear markets highlighted in a single shade of gray. The first thing that jumps out at us from this chart is that stock prices have generally tended to rise in the U.S. for nearly a century. A basic optimism has generally served equity investors well. Yet investment returns are mostly earned as a reward for bearing risk. Though it can be tough to see on a log scale, the price of the approximate 10% annual returns U.S. equity investors have earned has been the tendency for markets to take away half your money occasionally. Investors find this tendency highly irritating, and they expect their investment managers to deliver the most of that 10% upside while avoiding much of those nasty drops. Is such a thing possible, or are bear markets the inevitable cost of what has been mostly bull markets?

In Figure 1, we look at what we believe to have been the proximate causes of the prolonged bear markets since 1926, and we have categorized them as either: Valuation, Public Policy Surprises, Recession, or Other Shocks.

- Valuation – We have written a lot about the role of valuation in explaining future market returns in previous TT pieces. When valuations are higher than normal, they can go still higher for quite a while, but at high valuations, the market becomes quite vulnerable to bad news or shocks. The most recent example was the late 1990s bull market. Alan Greenspan warned of possible “irrational exuberance” in 1996, but the market would move much higher for nearly four more years before it crashed. Valuation is not a precise market timing tool, but it is a very useful investment tool. Very high valuations have often preceded bear markets.
- Public Policy Surprises – We have argued in previous TTs that some public policy changes that are often mentioned as huge drivers of the economy, like marginal tax rates, have not had as much long-term impact as some believe. But there can be no doubt that short-term, sudden changes in policy can have a profound impact on the markets. Perhaps the most dramatic such change in the past few decades was the decision by the Volker Fed to raise rates to record levels in the early 1980s as a way to crush inflation. The policy eventually worked, and many believe that it helped set the stage for the multi-decade bull markets in stocks and bonds that followed – but not before precipitating a nasty bear market in the short term.
- Recession – Recessions are often associated with bear markets, most dramatically during the Great Depression, but as we think about it, recessions often seem more like a by-product of something else rather than a primary driver of bear markets. Most recently, the Great Recession of 2008-2009 certainly contributed to the bear market, but the housing bubble/crash and excess leverage seemed like the causes and the recession the effect.
- Other Shocks – Shocks of various types (including the housing crash and financial panic) have often contributed to bear markets, for example the OPEC embargo and huge oil price increases of 1973-1974 and 1979. By definition, however, shocks are tough to predict. War, terrorist attacks, a natural disaster, or some other event might turn out to be the driver of the next bear market, and investors need to be alert to every possibility. But we pretend no skill at predicting, for example, whether a major meteor might hit the earth in 2016, so we will skip the prediction of shocks as a way of anticipating the next bear market.

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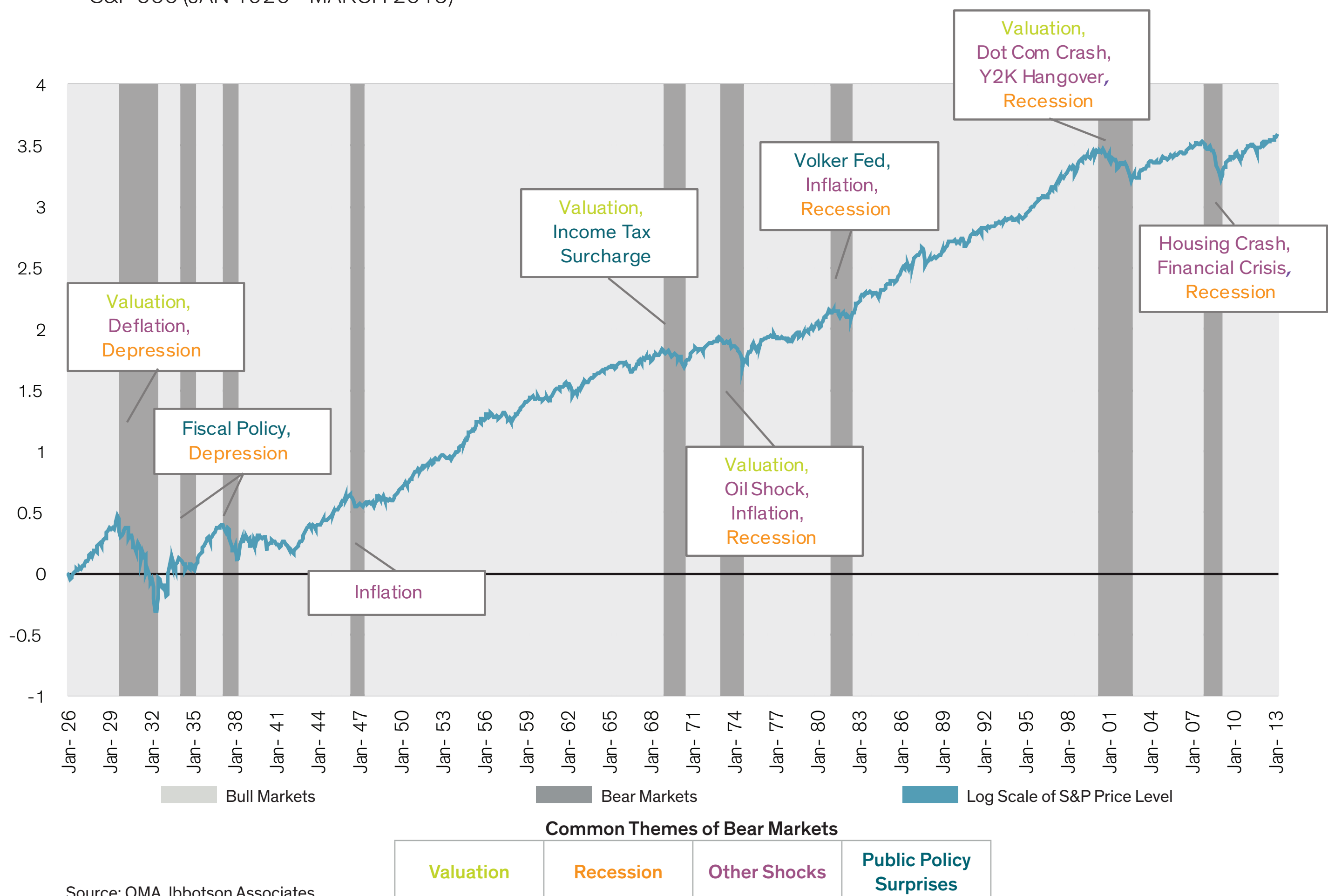
1 / WHAT ANGERED THE BIG BEARS?

S&P 500 (JAN 1926 - MARCH 2013)



Source: QMA, Ibbotson Associates.

What Could Trigger the Next Bear Market?

As we contemplate **Figure 1** and wonder what might trigger the next bear market, we believe that certain factors are unlikely to be the cause over the next couple of years. For example, valuations are not cheap, but in our view, they are not nearly high enough to cause a bear market in 2014. We do think that the somewhat above-average valuations and earnings growth that is above trend might constrain returns over the next decade or so to something below 10%, but that is not the same as predicting a bear market. Similarly, we argued in our mid-year 2013 TT that economic growth is likely to accelerate sharply in 2014, so we clearly do not expect a recession in 2014 or any time soon.

What about fiscal policy surprises? We argued in the last TT that fiscal drag hurt potential GDP growth in 2013 by 1-3%. It is possible that another deadlock over the budget and debt ceiling in early 2014 could spiral out of control and lead to a bear market. But in our view, a rerun of summer 2011 or fall 2013 is unlikely. And fiscal policy has been so negative for the economy for so long that we suspect that the market has largely accepted it and priced it in. We continue to think that growth will accelerate in spite of, rather than because of, fiscal policy. So what is left?

We think the two most likely causes of the next bear market are a burst in inflation and/or a sudden tightening of monetary policy. So for the balance of this white paper we will consider whether these might trigger a bear market starting in 2014 or 2015.

Is Inflation Likely to Substantially Accelerate Over the Next Two Years?

We have offered opinions about future inflation in several previous white papers. In a November 2009 piece, “Is Inflation Likely To Accelerate Soon?”[1] we concluded that a pick-up in inflation in the U.S. was “quite unlikely.” We had examined evidence supporting the monetarist view of inflation, best expressed in Milton Freidman’s claim that, “Inflation is always and everywhere a monetary phenomenon.”

In 2009 some prominent economists including Allan Meltzer[2] forecast that inflation was likely to soar soon because of aggressive policy actions by the Fed and other central banks. We showed that, empirically, the monetary base had not been especially highly correlated with inflation, and cited Alan Greenspan’s belief dating to 1996 that “Unfortunately, money supply trends veered off path several years ago as a useful summary of the overall economy.”

We also considered the evidence that the price of gold (soaring in

[1] Ed Keon “Is Inflation Likely to Accelerate Soon?” November 2009.
[2] Allan H. Meltzer, “Inflation Nation,” New York Times Op-Ed, May 4, 2009.

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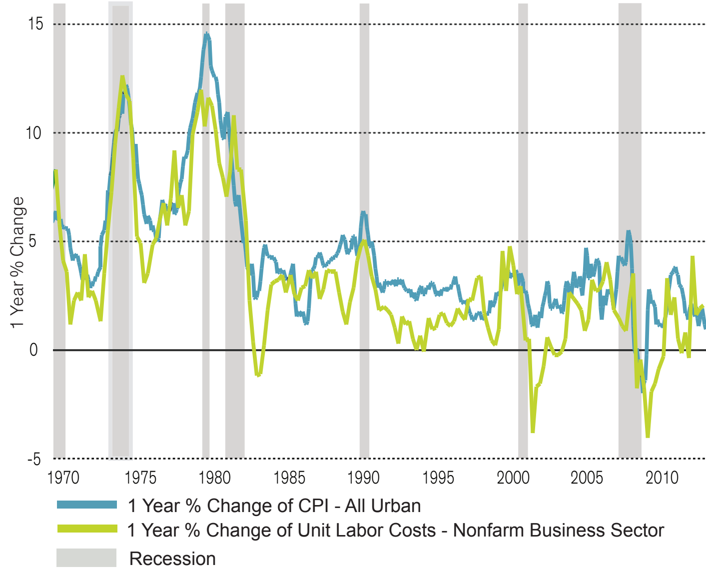
2009) or the price of oil offered reliable forecasts of future inflation, and found that evidence unconvincing. Instead, we offered the (now updated) graph in Figure 2, which shows that the change in unit labor costs, the total cost of hiring someone adjusted for productivity, had been highly correlated with inflation.

2/ U.S. INFLATION IS CORRELATED WITH LABOR COSTS

Inflation: CPI vs. Unit Labor Costs, (Dec. 1969 through Nov. 2013)



Source: Thomson Reuters Datastream, QMA.

At the end of the piece we concluded:

> "The labor market is simply too weak to support higher inflation. With strong productivity growth, businesses don't need higher prices to increase profits; indeed, we have seen profits improve recently almost entirely due to lower costs. Pushing higher prices on a weak consumer seems both a dangerous and unnecessary strategy. With a lowered cost base, even a modest increase in sales as the global economy recovers will probably lead to major profit improvements without alienating customers with higher prices. We think investors who buy inflation protection for 2010-13 will likely overpay for a product they do not need. But by the middle of the decade, it is possible that inflation might revive if a rash of baby boomer retirements coincides with an improving economy and higher asset prices."

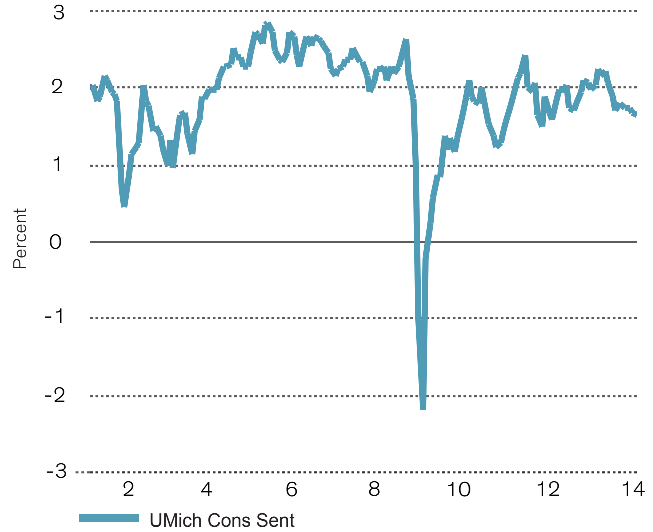
So the 2009 forecast held up pretty well: inflation has not accelerated. But it is the end of 2013, the end of the forecast horizon. So what about the last sentence? Baby Boomers clearly ARE retiring in large numbers, one of the key factors driving down the labor force participation rate. We argued earlier in 2013 that the U.S. economy will accelerate sharply in 2014, and clearly asset prices are much higher than they were in 2009.

So is inflation likely to accelerate soon? The short answer to this question is: probably not. That is, we think inflation will remain tame for at least a while longer, and possibly much longer. In part, this is just a simple reflection of reality: as Figure 2 showed, inflation is quite low and is trending down.

3/ INFLATION EXPECTATIONS ARE LOW AND TRENDING DOWN

Real Yields Versus Inflation Expectations

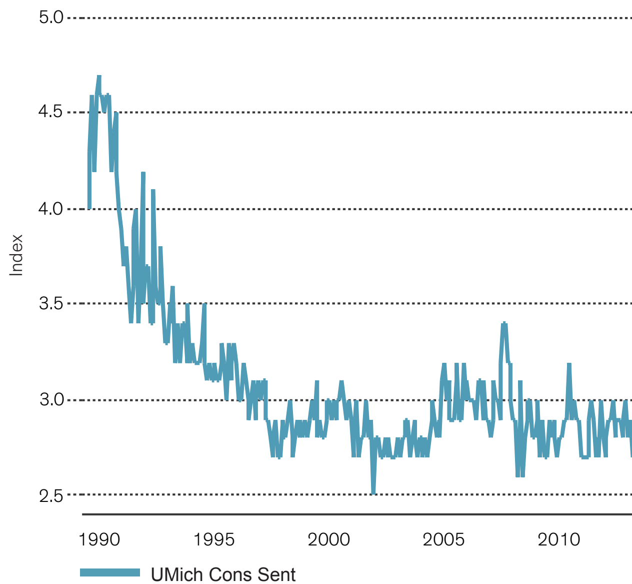
TIPS Market, 5 Year Constant Maturity
(Jan. 2001 through Dec. 2013)



Source: Thomson Reuters Datastream, QMA.

University of Michigan Consumer Sentiment

Median Expected 5 Year U.S. Inflation (Apr. 1990 through Dec. 2013)



Source: Thomson Reuters Datastream, QMA.

As the charts in Figure 3 show, inflation expectations are low and trending down. It would take a significant change in the environment to change the momentum.

We'll discuss a possible change driven by our expectations of strong economic growth a few paragraphs down, but first let's look at recent research on inflation and related topics.

What has changed our thinking ? There have been four more years of empirical evidence, especially from nations farther along in an aging population (e.g. Japan), and the notion that an aging labor force might lead to inflation has simply not happened so far (in fact, Japan has recently adopted policies designed to create inflation in an effort to reverse destructive deflation). We're quants. Empirics matter. As Keynes said, "Since the facts changed, I changed my position. What do you do, sir?"

But we also put a lot of faith in ideas: why and how things change. Over the past few years, there has been some very interesting work on demographics and labor force dynamics, and this work suggests to us that labor cost-driven inflation will at least be delayed and perhaps denied.

For example, a 2006 paper by Ivan Kitov[3] found that the rate of inflation was a lagged linear function of the rate of change of the size of the labor force. Kitov's work is certainly not mainstream thinking, and we would like to see further validation of his research. But the centrality of the labor market in driving inflation is related to our own thinking, so to us at least it has the ring of truth. And it has the important virtue that its out-of-sample results have been impressive: since 2006, inflationary pressures have eased, as labor force growth has slowed, rather than rising as monetarists had expected.

The research staff at the Federal Reserve Board has also produced a string of recent papers[4-6] that deal with the complex dynamics of inflation, labor force dynamics, and Fed policy. The Fed staff has been joined by others looking at demographics, income distribution, labor force dynamics, and other factors that might influence government policies, economic growth, and financial market returns. It some cases, this work is driven by ideological issues from either the left or the right. But in most cases, the research is trying to make sense of the post-crisis world, and assess the likely course of future events.

> We stand at an intersection of a relatively rare event, a global financial crisis, the worst in seven decades; an unprecedented event, the rapid aging of the population of many of the world's most important nations; and an unprecedented expansion of monetary policy. How will economies react? How will people and their elected and appointed representatives react? How will markets react? The jury is still out, but it is a fascinating time for research.

Though research may eventually conclude that demographics are the most important drivers of inflation, that is certainly NOT the current conventional wisdom. As discussed above, monetarists believe that the money supply is the key determinant of the inflation rate. The current Fed Board, however, seems more inclined to embrace the notion that there is a trade-off at some point, between unemployment and inflation (the Phillips curve), or that there is some "natural rate" of unemployment below which unacceptable inflationary pressures build.

What Will the Fed Do?

The Fed has said that it will maintain highly accommodative policies as long as the unemployment rate is above 6.5%, but has been careful to say that falling under 6.5% is not a "trigger" for tighter policies. What is the "natural rate" or "Non-Accelerating Inflation Rate of Unemployment" (a.k.a. "NAIRU"), above which inflation remains tame? No one knows for sure, though the Fed has suggested that this rate is below 5.5%.

Yet as we look at the historical data on unemployment and inflation in the U.S, we see very little relationship. We have had periods of high unemployment and high inflation in the 1970s and periods of low unemployment and low or falling inflation in the early-mid 60s, the 80s and 90s. However, our reading of the actual relationship between unemployment and inflation is not as important in the short run as the fact that the Fed and the markets believe that there is such a relationship.

> If the economy accelerates as quickly as we believe that it will, we think that the unemployment rate might fall faster than most project, with potential negative implications for the market.

We expect to breach the 6.5% level in 2014, and we would not be shocked to see 6% in late 2014 or (more likely) the first half of 2015. If we are correct, the Fed might contemplate tightening policy and consider raising the Fed funds rate sooner than market participants predict. Markets tend to react suddenly and sometimes violently to surprising changes in Fed policy – or even the possibility of such. If investors conclude that the Fed is "behind the curve" of inflationary pressures, a sharp correction or even a bear market is possible.

> We suspect that the next threat (though not necessarily the reality) of a bear market will arise from either a suggestion of accelerating inflation, the reaction to an unexpectedly hawkish Fed response to the threat of higher inflation, or both.

Will a market drop over the possibility of higher inflation and/or Fed tightening due to lower unemployment lead to a full fledged bear market, or will it only be a garden-variety correction from which the market quickly recovers? Of course we can't say for sure, but we think that will hinge on how the economy actually behaves. That is, investor and policy-maker anxieties can cause a correction, as we saw in the summer of 2011; but if reality turns out to be not as bad as the market feared, then the correction can quickly reverse course.

Above all, we are fundamentalists. We believe that Fed policy ultimately matters to the extent that it influences the real economy.

As we laid out in our mid-year white paper, we think that slack capacity, pent-up demand, improved access to credit, less fiscal drag, and eventually a fiscal boost will lead to rapid non-inflationary growth in 2014 and the next couple of years. We have seen plenty of

[3] Kitov, Ivan, "Inflation, unemployment, labor force change in the USA," ECINEQ 2006-28, March 2006.
[4] Dave Reifschneider, William Wascher, David Wilcox, "Aggregate Supply in the United States: Recent Developments and Implications for the Conduct of Monetary Policy," November 2013.
[5] Regis Barnichon, Andrew Figura, "Declining Labor Force Attachment and Downward Trends in Unemployment and Participation," October 2013.
[6] William B. English, J. David Lopez-Salido, Robert J. Tetlow, "The Federal Reserve's Framework for Monetary Policy," November 2013.

precedents for strong growth with low or declining inflation in the U.S. in the 1950s, 60s, 80s, and 90s. The Fed's task of transitioning to a more normal policy will no doubt present substantial challenges. But with the added policy tool of the ability to pay interest on reserves, we think that it is up to the challenge.

Our best guess is that we will see more volatility over the next few years, but that the bull market will keep running.

Volatility was extraordinarily low in 2013; we never came close to a 10% correction and barely threatened a 5% drop a couple of times. From that low level, volatility is quite likely to rise. Markets were surprised by economic strength and stability in 2013, hence the 30% equity market gains in the U.S. Even the events in Washington D.C., which rattled markets and caused a 20% correction in 2011, seemed to pose no problems in 2013. The only source of volatility was, in fact, concern about changes in Fed policy. But in retrospect, those modest Fed-induced drops were buying opportunities. Our best guess is that we will have more Fed-induced market drops, but we think these might once again turn out to be opportunities, not threats.

Might the Disappointment of Missed Christmas Eve Deliveries Portend a Better 2014?

Changing gears a bit, it has been widely reported that the major package delivery services could not satisfy the surge in demand from online purchases on December 24. Our guess is that there was a silver lining to the disappointments and frustrations of Christmas Day. The New York Times reported that one major carrier had hired the same number of part-time workers for this season as last. This suggests that other factors, like distribution centers, computer hardware and software, trucks, etc. were also not increased substantially more than previous seasons. We suspect that package delivery services, along with nearly every other industry in America, have operated conservatively over the past few years. Since, until recently, pick-ups in demand have proven temporary, conservatism has seemed prudent. Irate merchants and delivery customers might change the status quo. Low investment and slow hiring can change quickly if the alternative is to lose business to competitors. If so, the economy might add to capacity as businesses put their ample cash and strong borrowing power to work. Those additions to capacity could help to ease or at least delay inflationary pressures.

Conclusion

Bottom Line: we do NOT think a bear market is on the horizon today.

Pontificators must live in fear of being the next Irving Fisher. James Tobin and Milton Friedman called Fisher, "The greatest economist the United States has yet produced." His theory on debt deflation was supported in the events leading to and following our recent financial crisis. He was the preeminent economist of his time, but he is best remembered today as saying, just before the crash of 1929, that, "Stock prices have reached what looks like a permanently high plateau." As Rick Perry said, "Oops!" Yet despite our fear of being filleted like Fisher, we believe that the conditions that typically foreshadow bear markets do not exist today. We expect volatility to increase (and rescue our moniker for the decade), but we think it quite unlikely that a bear market will start in 2014 or 2015.

As we have acknowledged from the beginning of this TT series, we are undertaking a fool's errand. Some quotations are so profoundly true that they are attributed to several people; so it is with, "Prediction is very hard, especially about the future." (Among those who might have said this: the physicist Neils Bohr, the poet Piet Hein, the philosopher Yogi Berra, and others.) Yet the present value of an investment is the discounted value of its future cash flows. As unpredictable as cash flows and appropriate discount rates might be, we must estimate them to determine approximate worth and expected return today. So while admitting that our efforts might expose us to justifiable ridicule, we try.

Our present situation is somewhere between unusual and unprecedented.

The financial crisis and the political and policy reaction to it will influence the economy and the market for some time to come. But as we have written in past Turbulent Teens white papers, the underlying strengths of the US economy remain formidable. The recent and, we think, long-lasting progress on energy production, the great innovation from new technology, and a renewed prudence born of the recent crisis, will add to our legacy. Challenges remain, but we expect that the economic expansion and bull market still have quite a ways to run.

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