Hearing Echoes Of 1987

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In the first four articles in this series, I explained why I believe that a structural bull market in equities began in late 2012 and is likely to continue well into the next decade (see **The Case For A Structural Bull Market**). But bull markets do not just keep rising without interruption. Sooner or later, equity investors are certain to suffer some large and painful losses, even if I am absolutely right about the economic, monetary and valuation reasons for long-term investors to favor equities over cash and bonds.

Equity investors will suffer 'large and painful losses'...

So in this, the final article in the series, I will consider what events are likely to trigger the large and painful losses that are sure to hit equity investors at some point. First, let's define some terms. By 'large and painful losses' I do not mean the regular corrections of -5% or -6% experienced by the S&P 500 and the MSCI Europe indexes since equities started to outperform bonds in mid-2012. Nor do I mean the -19% peak-to-trough fall of the S&P 500 in the 2011 Treasury default panic or the -18% decline of the MSCI Emerging Markets index during last year's 'taper tantrum'. Setbacks on this scale are essentially random events which should be disregarded as 'white noise' as long as the signal of a clear uptrend remains intact—which it has since 2009 in the US, and since mid-2012 in all the other big equity markets. As long as this upward trend continues, increasing numbers of investors will treat such corrections as buying opportunities, which in turn will reinforce the trend.

A genuinely scary correction?

The question therefore is what could trigger a correction considerably deeper than -20%, such as the ones that occurred in Europe and the emerging markets in 2011 (both the eurozone and EM indices plunged by -32% between May and September that year). The obvious answer is a major economic or political crisis such as the near breakup of the euro between the summer of 2011 and the autumn of 2012. Another possible cause of a genuinely scary correction would be a substantial monetary tightening, such as the ones that triggered the US bear markets of 2007-09, 2000-02, 1980-82 and 1973-74.

...but not just yet

If, however, we accept the view of my previous articles that there is no major economic crisis or substantial monetary tightening on the horizon, at least for the next year or two, then we must draw one of two conclusions: either equity prices will just keep on rising without interruption, or the next bear market will be caused by something other than economic fundamentals or liquidity conditions. In this case the most plausible culprit would be the internal dynamics of the equity market itself: extreme and unsustainable valuations caused by excessive investor optimism and momentum trading.

A lot of people claim that stock markets are already in this dangerously speculative condition, but this claim makes no sense for two reasons:

There is little chance of fresh economic or monetary shocks in the next year

1) Standard valuation metrics are only just above their long term averages in the US and are lower than average in most other markets, as I explained earlier this summer (see **Shiller's Snake Oil**). Thus the claim that prices are unusually over-extended is difficult to substantiate with statistics. Of course, bears can always argue that corporate profits will soon start falling or that interest rates will rise sharply, but that would just bring the debate back to predictions about economic growth and monetary policy. So if my forecast of no major change in either economic or liquidity fundamentals turns out to be correct, then today's valuations are no cause for concern (see **The Global Obsession With US Data** and **Monetary Policy Is No Threat To Markets**).
2) The market's behaviour itself confirms that today's valuations are not unreasonably demanding. We know this because investors have repeatedly responded to big exogenous shocks by buying more equities instead of selling in a panic. Had valuations been genuinely over-extended, then investors would have sold equities much more aggressively in response to bearish catalysts like the withdrawal of liquidity by the US Federal Reserve, the stalling of US growth last winter, or disappointment (yet again) with Europe's economic prospects, not to mention the wars in Iraq and Ukraine.

Which leads me, finally, to the bad news with which this generally bullish series has to end. If valuations are not yet high enough to cause big losses to investors, and if I am right in my belief that monetary and economic conditions will remain benign, at least for the next year or two, then the unavoidable conclusion is that equity prices will keep on rising until they reach a point where valuations really are dangerously over-extended. At some point valuations will become so stretched that the sort of negative news investors can shrug today off as irrelevant will be enough to trigger a serious bear market.

Far from over-stretch

Valuations are not high enough to trigger a major setback

What level of valuations will be high enough to make the market vulnerable? And when that point is reached, what news event will act as the catalyst for the selloff that, sooner or later, is bound to happen? These questions are impossible to answer. But we can be fairly sure of two things: (i) that valuations today are *not* yet high enough to trigger a major setback and (ii) that a valuation-driven bear market, when it does happens, will come as a shock to analysts because it will seem an excessive response to some fairly minor catalyst in economic, monetary or political fundamentals.

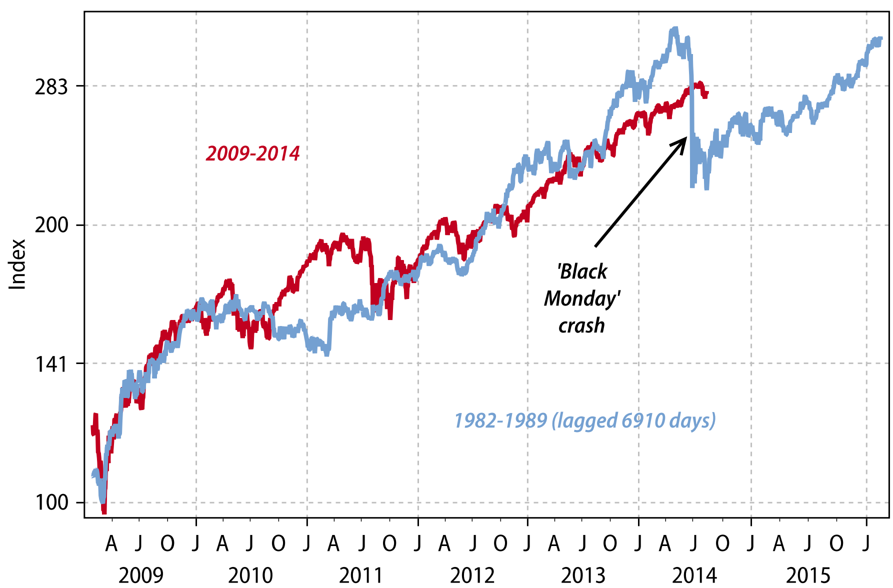
In this respect, the present stock market environment is much less reminiscent of 2007, when global equity prices were at similar levels to today, than of 1987. That year, like 2014, came five years into a structural bull market that nobody expected when it started in late 1982. And even after four years of almost uninterrupted gains, nobody trusted that bull market because in the mid-1980s nobody believed that the Great Inflation responsible for the appalling investment losses of the 1970s had been genuinely and permanently defeated. In 1987, however, the sceptics threw in the towel. Investors and analysts who still didn't understand or trust the market's advance, decided to buy anyway. As a result, the gains suddenly accelerated from 25% annually in the first four years of the bull market to 40% in the eight months from January to August 1987. This surge was almost entirely a valuation-driven multiple expansion: between December 1986 and August 1987 the historic P/E ratio for the S&P 500 surged from 16.7 to 22.3. The rest is history—the biggest stock market crash in history. On 'Black Monday', October 19, 1987, Wall Street gave up its entire year-to-date gain in a single day. Although on a long term chart that crash is now an almost invisible blip, it certainly didn't feel that way at the time.

There are no signs yet of a pre-crash acceleration in stock prices

Something similar may well be in store for this market cycle. But now for the good news. Although the performance of the US stock market from 2009 to 2013 was very similar to its behaviour in the four years after it bottomed in August 1982, this year there has been no sign of the acceleration that preceded the crash in October 1987 (see chart below). Although history never repeats itself exactly, this chart suggests two intriguing possibilities. Maybe investors in this bull market will remain cautious for much longer than they did in the 1980s, thereby keeping valuations moderate and avoiding the roller-coaster ride of 1987. Alternatively, it is possible that the time-line has simply been stretched by a year or so and the period of acceleration is just about to begin.

Either way, it seems too early for long-term investors to panic, or even to reduce risk. But it may well be time to fasten seatbelts, buy some insurance, and prepare for the possibility that the next boom-bust cycle, instead of approaching its climax is only just beginning.

S&P 500 1982-89 and 2009-14 (rebased to Mar 2009)



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