Early Thoughts On The Next Bear

Prepared by: *Doug Ramsey, CFA, CMT*

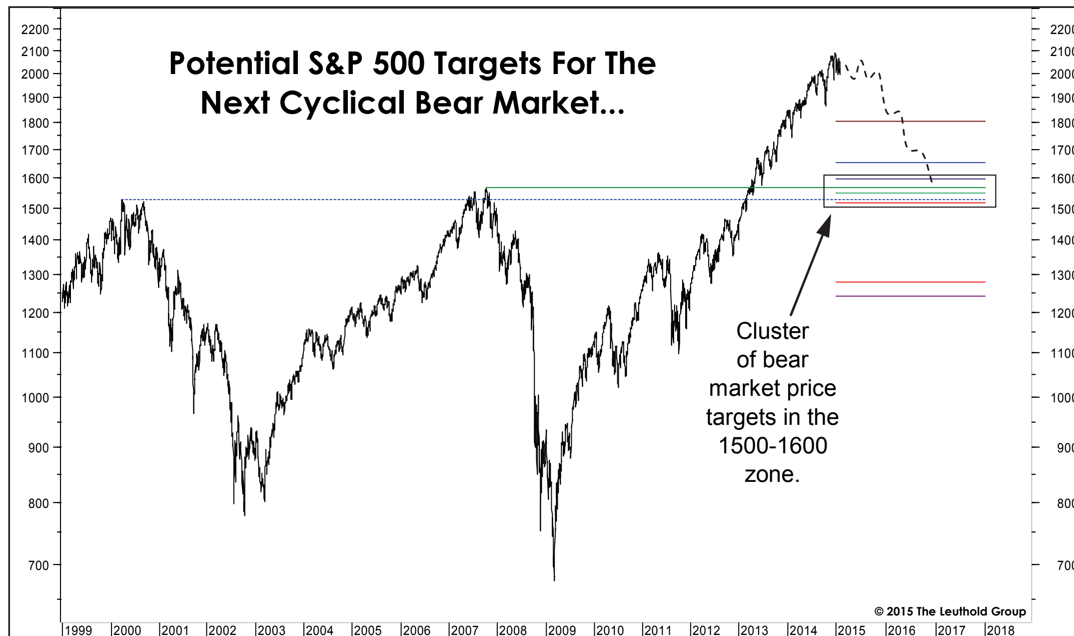
Question: Last month you discussed the possibility of a 25-30% cyclical bear market erupting in 2015 or 2016. Where did those numbers come from?

Response: Those levels straddle the median postwar S&P 500 bear market loss of **–27.5%**. We expect a "garden variety" cyclical bear market to break out this year or early next year. (I should clarify that the parallels drawn between recent market action and 2007 are for the purpose of comparing the respective topping processes—not to imply a painful smash like 2008-09 is in store.)

Few may see it this way, but a merely **average** cyclical bear market **might be viewed as a kind of moral victory** in the wake of:

- The fourth best cyclical bull market in postwar history (+209% on the S&P 500);
- The third-longest postwar bull market (69 months into the December 29th top);
- Moderate overvaluation on the major indexes and more severe overvaluation of the "median stock";
- Record overvaluation of bonds, a competing asset class;
- Six-plus years of pure experimentation in Fed policy

Next, consider what a normal cyclical bear market might look like—literally. The chart presents a possible path of decline that terminates within a "cluster" of targets in the 1500-1600 zone. Does this hypothetical move "look" all that significant in the context of the last two decades? Hardly.



If the next cyclical bear market low were, by chance, contained within or near that cluster, **and** the ensuing rebound was accompanied by some measure of normalization in monetary (and perhaps fiscal) policies—**we'd have to consider it a favorable outcome for almost all involved**… except, perhaps, for S&P indexers. No, reverting to levels first seen in 2000 (S&P 500 at 1527) and 2007 (1565) wouldn't be fun, but those prices are within a "normal range" of outcomes. (We study history now so we won't be surprised later.)

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Here are the calculations behind a mix of potential fundamental, technical, and historically-derived bear market lows shown in the 'possible path of decline' chart. We'll adjust them in the event of a blow-off beyond 2200-2250. But a bigger blow-off would, in our minds, be followed by a bigger bust—not the garden-variety one considered here.

S&P 500 Potential Bear Market Lows:

- **1241**: Reversion to the postwar median S&P 500 Price/Sales ratio of 0.98x (from 1.64x).
- **1279**: Decline to postwar median S&P 500 Price-to-Book of 2.08x (from 3.40x).
- **1516**: Median postwar cyclical bear market decline of –27.5%.
- **1527**: Secular bull market top of March 24, 2000.
- **1550**: Standard technical retracement of 38.2% of gain from March 9, 2009.
- **1565**: Top of 2002-2007 bull market.
- **1595**: 50% retracement of the gain off the October 2011, S&P 500 low of 1099.
- **1650**: Decline to postwar median S&P 500 Price/Cash Flow of 9.4x (from 11.9x).
- **1805**: Decline to postwar median S&P 500 Normalized P/E of 17.7x (from 20.5x).

Note that among the various targets, **a reversion to the median Normalized P/E ratio implies the least market downside**. This particular measure gained fame within our shop when it pinpointed the October 2002 bear market low to the day. **During the last bear market, though, "reversion to the median" was followed by another 13 months of market losses.** These levels are nothing more than guideposts, and we'd place more significance on those that cluster together in price.

Finally, the shallow decline projected by a reversion to the "normal" Normalized P/E ratio stands in contrast to the large losses implied by reversions to median valuations based on **book value** and **sales** (both imply a bear market low below 1300). The **disparity suggests that profit margins have been so high for so long that even our trusted Normalized P/E has become warped**. Left to their own devices, markets and economies have a natural way of fixing those warps. When not left to their own devices, they fix them in an especially violent fashion—but later.

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