“You Know, It’s a Bull Market!”

After spending many years in Wall Street ..., I want to tell you this: It was never my thinking that made the big money for me. It was always my sitting. Got that? My sitting tight! It is no trick at all to be right on the market. You always find lots of early bulls in bull markets and early bears in bear markets. I’ve known many men who were right at exactly the right time, and began buying or selling stocks when prices were at the very level which should show the greatest profit. And their experience invariably matched mine – that is, they made no real money out of it. Those men who can both be right and sit tight are uncommon. I found it one of the hardest things to learn.

Edwin Lefevre, *Reminiscences of a Stock Operator*, 1923

Investors are more relaxed today than at any time in the last three years, and for good reason. A genuine bull market is underway. Stocks are about 25% higher now than they were in late July a year ago. And as Jesse Livermore wrote in *Reminiscences of a Stock Operator* eighty years ago, it is important for investors to “sit tight” and let the market do the work.

Jesse Livermore, whose *nom de plume* was Edwin Lefevre, was a legend on Wall Street. Born in 1877 in Shrewsbury, Massachusetts, Jesse started working in brokerage houses and “bucket shops” at the age of fourteen. His father was a poor farmer who handed him a pair of overalls when he finished 8th grade and told him it was time to quit school and contribute to his family’s welfare. With five dollars in his pocket, Jesse started work at Paine Webber in Boston as a chalkboard boy, posting the prices of stocks traded on the New York Stock Exchange as the telegraph reported them. At the conclusion of the Panic of 1907, when J.P. Morgan almost single-handedly saved the U.S. financial system, Livermore, just 30, was worth $3 million – after having made and lost three lesser fortunes. Many of the rules that stock and commodity traders currently follow were first articulated in Livermore’s *Reminiscences of a Stock Operator*. Tragically, Livermore could not translate his success in business life to his personal life and took his own life in 1940. His autobiographical work is a must read for investment professionals and for all who want to understand trading patterns in the stock market.

In his book, Livermore tells the story of a wise, old stock market investor named Partridge, who frequented the broker house where Livermore worked. Partridge was nicknamed Turkey for the way he strutted around with the point of his chin resting on his breast. He never volunteered tips, asked for advice, nor whimmed when a stock declined, but was known to be rich. When other customers would ask him for advice on one stock or another, old Turkey would contemplate his fellow customer with a fatherly smile and finally he would say very impressively, “You know, it’s a bull market” – as if it was the most priceless advice. One day, another customer came rushing up to old Turkey and told him to sell his Climax Motors as he had done, as the stock market was “entitled to a reaction” (a correction), and he would be able to buy back the stock cheaper. However, old Turkey refused to sell his shares. He kept repeating the phrase, “It’s a bull market, you know.” When pressed to explain his repetition of this phrase, old Turkey replied:

“If I sold that stock (Climax Motors) now, I’d lose my position; and then where would I be? I would not lose my job, but I would lose my position. And when you are as old as I am and you’ve been through as many booms and panics as I have, you’ll know that to lose your position is
something that nobody can afford; not even John D. Rockefeller. I hope the stock reacts and that you will be able to repurchase your stock at a substantial concession, sir. But I myself can only trade in accordance with the experience of many years. I paid a high price for it and I don’t feel like throwing away a second tuition fee. But I am as much obliged to you as if I had the money in the bank. It’s a bull market, you know.”

The New Bull Market

Yes, it’s July 2003, and a powerful bull market has been underway for some months. This bull market started on March 12 – several weeks before the Iraq war commenced. On that day, the stock market re-tested its July 2002 and October 2002 lows and rebounded to close up for the day. Since then the S&P 500 Index is up over 20%, and the NASDAQ Composite has advanced over 30%. In mid-April, the broader market averages crossed the 200 day moving average and have stayed in a confirmed rally with distribution days occurring infrequently. The bull market is predicated upon the assumption that the monetary and fiscal policies that are being undertaken will cause, as they have in the past, a tepid U.S. economic recovery to turn into a strong one. GDP growth of 3-4% will, in turn, cause corporate profits to rise, and this will result in a virtuous cycle of more business spending, greater job creation, and higher consumer spending. This bull market is built squarely on the following four pillars: rising corporate profitability; low interest rates and the promise of higher returns in stocks than money market funds and bonds; deficit spending and lower taxes; and the reduced probability that acts of terrorism on U.S. soil will take place. Let’s consider them one by one:

Rising Corporate Profitability

The U.S. economy emerged from recession in November 2001, according to recent reports. Corporate earnings are recovering strongly, and the quality of earnings is improving, too. Earnings quality has been greatly helped by the recent accounting scandals, which had the effect of focusing attention on shoddy accounting. Under pressure from investors, corporate America has been cleaning up balance sheets and income statements. The expensing of stock options will reduce the use of options and cause more companies to use restricted stock grants. S&P 500 operating earnings, which dropped from $56.13 in 2000 to $38.85 in 2001, are forecast this year to come in at $51.50. Many investment houses are predicting S&P 500 operating earnings for 2004 of $57.00 or more, which would be an all time high. The strong 2003 earnings for many growth companies have been aided by cost cutting and, in part, by the weaker dollar.

Equity Returns Attractive Compared to Bonds and Money Market Funds

Investors are starved for yield. The average money market fund pays approximately 0.5%. Bonds, which have been another safe haven for investors, have only modest yields. The two-year U.S. Treasury note yields only 1.5%, while the five-year Treasury note has a yield of 2.9%. Moreover, interest rates have begun to back up significantly. The ten-year U.S. Treasury note which yielded recently only 3.07% has jumped rapidly to a yield of 4.07%. The year-to-date total return for this bond is barely 1%. Meanwhile, investors over the past three years have doubled their holdings of cash in the form of money market funds, savings accounts, and other short-term CDs to $4.7 trillion. Where will all this money go in search of higher returns, as the fear of loss continues to subside? Much of it will likely find a home in quality stocks with good dividend yields. Although the S&P 500 Index only yields 1.6%, there are many quality growth stocks yielding 2-4%, and most of these companies increase their dividend payments each year. We believe that the recent change in the taxation of dividends (see below) will accelerate this flow of funds from money market funds and bonds to stocks, putting a floor under the stock market.
Beneficial Fiscal and Monetary Policies

While the Federal Reserve has been combating the threat of deflation with expansive monetary policies, the administration has been doing its part to spur economic growth through a two-part fiscal strategy. The first has been to cut taxes. The recently enacted income tax legislation will put more money in the hands of the consumer which should spur spending. Moreover, the new tax law, which treats capital gains and dividends equally at 15%, will cause many companies to increase the payment of dividends and cut back on the repurchase of stock, thereby lifting the dividend yields of their stocks. In our view, this is a major, positive change for investors. The second part of the equation is to tolerate a large deficit, which, according to traditional economic theory, is the proper approach when trying to bring an economy from recession to growth.

Lower Risk of Major Acts of Terror on U.S. Soil

Having suffered devastating terrorist attacks on U.S. soil on September 11, 2001, the policy of the Bush administration is to take the war on terror to the terrorists. In effect, the policy is: Better to fight Islamic terrorists on their own soil than here in the U.S. In spite of the dangers involved and the difficulties involved in accomplishing major change in Afghanistan and Iraq, the majority of the American people seem to support this approach. Only time will tell if this good-offense-is-the-best-defense strategy is effective, but it does appear as if the perceived risk level of another major terrorist attack in the U.S. has moderated.

The 2003 Bull Market: What Kind is it?

There are three kinds of bull markets: a bull market rally in the midst of a secular bear market; a cyclical bull market; and a secular bull market. Which market are we in now? The bears believe that this four-month bull market is just another rally in a secular bear market (secular in this case meaning a longer period of time). An example of a secular bear market is the Japanese stock market in which the Nikkei Index fell 80% from 40,000 in 1989 and now trades at 9,000. The bears point to the fact that there have been four rallies of 25%+ in the NASDAQ Composite since its peak in March 2000, and each time the NASDAQ has resumed its decline. They hold that this fifth rally is the same as the previous failed ones. We do not subscribe to this view but would change our views if global deflation became a reality. The other scenario which could cause a decline in GDP would be a series of major terrorist events on U.S. soil.

The second kind of bull market is a cyclical bull market. This is the type of bull market that investors encountered from 1965-1982. During this 17 year period, the Dow Jones oscillated between 500 and 1000. The stock market had to deal with the Vietnam War, assassinations, OPEC, Watergate and the resignation of a President, stagflation, and runaway inflation. While the stock market undulated, the economy grew, and there were periods when investors could make very good money. It is possible that the current bull market is a cyclical bull market. If strong economic growth causes interest rates to rise faster than corporate earnings, this could cause the stock market’s P/E ratio to contract. Thus the market might stagnate or even decline as higher earnings would be offset by lower market multiples as inflation re-accelerates. In this scenario, the Dow Jones could oscillate between 8,000 and 10,000 for some years until the stock market broke out of the cycle. The chart on the following page shows the S&P 500 during this period.
The third scenario is that the stock market has entered into a new secular bull market. An example of this is the chart below showing the secular bull market between 1982-1999:

If this market is a new secular bull market, one reasonable scenario could be 8% average growth in the operating earnings of the S&P 500 Index reaching $110 in 2012. A P/E ratio of 18.2 would translate into an S&P 500 of 2000, doubling from its current level. This would translate into an average annual return of roughly 10%. Is this a cyclical or secular bear market? We don’t know yet, but we agree with Jesse Livermore that sitting tight, while holding quality growth stocks in a bull market, is the way to make good money.

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