July 2009

In the Midst of a Secular Bear Market

> The present conditions, however distressing, especially in terms of human suffering, reflect a passing phase in our history. In the context of American progress, the Depression was a bad quarter of an hour.
>
> Andrew W. Mellon, Secretary of the Treasury (1921-1932)
> as quoted by Amity Shlaes, *The Forgotten Man*, 2007

> The long run is a misleading guide to current affairs. In the long run, we are all dead.
>
> John Maynard Keynes, *A Tract on Monetary Reform*, 1923

Recently, there has been much talk in the financial media about the U.S. stock market being in a secular bear market. In speaking with some of our clients, we have been asked about the meaning of the term, "secular bear market," and what it portends for investors. Like most investors, our clients were greatly relieved that the S&P 500 reached a bottom at 666 on March 6. They were also very thankful that the stock market has since rebounded approximately 35% to the 900 level. Nevertheless, there is little joy that the S&P 500 is more than 40% down from its October 2007 high. In fact, the S&P 500 is lower than where it was on January 1, 1998 – 11½ years ago. An eleven-year period where a stock market has made little progress looks very much like a *secular bear market*. The chart below shows how the strong bull markets of the late 1990s as well as the period from 2003 through most of 2007 did not compensate for the two savage bear markets during 2000-2002 and the most recent crushing drop from October, 2007 through March, 2009:

The Current Secular Bear Market

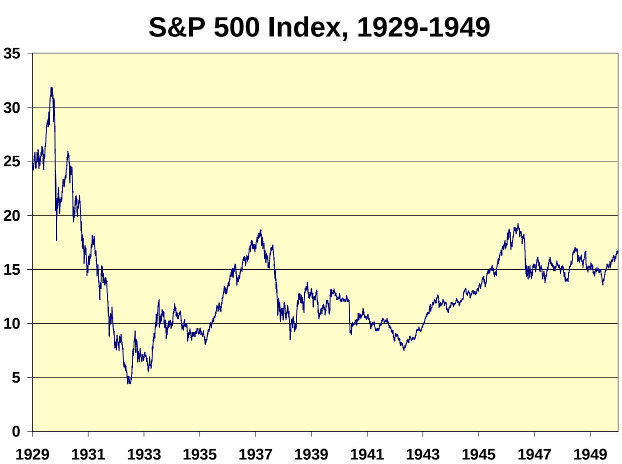
A Definition of Secular Bear Market

There are two parts to the term *secular bear market*. A bear market is a steady drop in the stock market over a period of time ranging from several months to several years. During a bear market many investors are pessimistic, a gloomy market psychology often triggers widespread selling of stocks, and a negative feedback cycle emerges. According to generally accepted definitions of market trends, the stock market needs to drop by at least 20% during a period of several months or more to be called a bear market. The most recent bear market was the 18-month period between October, 2007 and March 6, 2009, during which the S&P 500 Index dropped from its all-time high of 1576 to 666 – a decline of 57.7%.

A *secular bear market* is a long-term trend (a decade or longer) during which the damage to stock market prices during periodic bear markets is as great or greater than upward price movements during the minor bull markets that take place during this same period. Accordingly, the result of a secular bear market is a 10+ year period when the overall stock market makes little or no upward progress. Great attention is paid to concepts such as secular bear and bull markets, as many investors believe that markets have regular trends and patterns that are repetitive. Markets often behave in observable patterns, many analysts believe, because human nature does not change: the emotions of optimism and exuberance, ambition and greed, skepticism and pessimism, fear and panic are ever present whenever speculators and investors are involved in a market. By studying patterns of how past markets have behaved during times of similar economic opportunities and challenges, investors seek to design strategies to preserve capital in times of severe economic and market dislocation and even profit from these turbulent times.

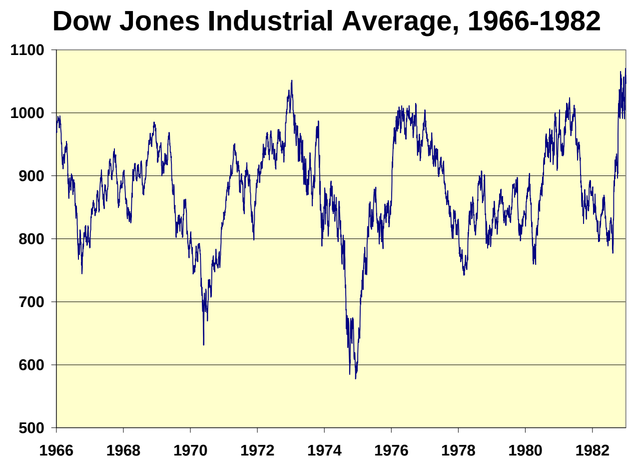
During the 20th century, there were three clearly identifiable secular bear markets. The first secular bear market lasted from 1906 through 1921. This 16-year bear market encompassed the famous Panic of 1907 (when J.P. Morgan saved the U.S. financial system), World War I and its deflationary aftermath. During this period, the Dow Jones Industrial Average had an average annual gain of 2%, although the dividend yield on the Dow was 4-5%. This period was followed by a seven-year stretch from 1922 through 1928 when the Dow Jones had an average annual gain of 18% per year. The Dow Jones tripled during the roaring '20s. In 1929, the market crash helped cause the Great Depression which ushered in the second and longest secular bear market in the 20th century. Many market historians mark this secular bear market as lasting from 1929-1949. Others count it only through the Battle of Midway in May, 1942. According to the *Ibbotson SBBI 2009 Classic Yearbook*, the S&P 500 Index had an average annual decline (price gain or loss plus reinvested dividends) of .1% from 1930-1939. Then from 1940 through 1949, the S&P 500 Index produced an average annual return of 9.2%. The chart below shows the S&P 500 Index for the entire 21-year period:

The Great Depression, World War II and its Aftermath



For the 16-year period from 1950 through 1965, the stock market roared ahead with the total return of the S&P 500 Index increasing more than *elevenfold*. Successive pro-business administrations in Washington created prime conditions for businesses to prosper leading to modest inflation and corresponding low interest rates, declining levels of taxation, and less regulatory pressure. These positive macro conditions plus rapidly growing consumer demand engendered growing confidence in the business community, and this, in turn, triggered strong business investment. Corporate earnings exploded amidst robust GDP growth. However, starting in the mid-1960s, the Vietnam War, rising inflation, the growing current account deficit, social unrest, constant political turmoil and the OPEC oil shock all combined to cause the next secular bear market.

Vietnam War, Stagflation & Watergate



The 17-year period between 1983 and 1999 was a golden economic period in the U.S. It was interrupted by only one modest recession in 1990-1991. The political and economic programs, commenced in the Reagan administration and embraced by later Democratic and Republican administrations, produced almost two decades of low inflation, falling interest rates, lower taxation, and less government regulation. An investment of $100,000 in the S&P 500 Index in 1983 grew to $1,274,400 (with dividends reinvested) by the end of 1999. However, by 1999, exhilarated by the promise of the Internet, investors had pushed up the S&P 500 Index's P/E ratio to almost 30. This market overvaluation was one of the prime causes of the current secular bear market. Other economic dislocations which laid the groundwork for this secular bear market included a housing boom, a personal consumer savings rate in the U.S. which fell to zero, mounting debt at all levels of the economy, and an enormous trade imbalance and current account deficit, which weakened the dollar and helped cause an explosion in energy and food prices.

Is Capitalism a Failed System?

With unemployment currently at 9.5% and projected to rise to 10% or more by the end of 2009, the U.S. is in the midst of the worst economic recession since the early 1980s, when the unemployment rate hit 10.8%. The Panic of 2008 came close to bringing the U.S. financial system to its knees last fall, and only rapid and massive government intervention prevented the system from failing – both here and abroad. The effect of the Panic on the U.S. economy has been very damaging. While many nonbanking corporations are in reasonable shape, the banking system as well as the consumer and public sectors (especially states and cities) are definitely not. Both the consumer and public sectors will need to go through an extended period of belt-tightening to regain financial strength. Naturally, there are those in this country who are questioning the capitalistic system itself (as occurred in the 1930s). They see the need for the government to provide the economic impulse which the private sector currently lacks. They point to FDR's massive government intervention in the 1930s as the panacea for what ails us now. In President Roosevelt's 1937 Inaugural Address, he forecast a world of ever greater government involvement: "We are beginning to wipe out the line that divides the practical from the ideal; and in so doing we are fashioning an *instrument of unimagined power* for the establishment of a morally better world." However, in analyzing the Depression years in *The Forgotten Man*, Amity Shlaes shows that the unemployment rate of 20%+ in the autumn of 1937 was at roughly the same level as in 1933 when Roosevelt took office. Roosevelt's experiments in state capitalism such as the NRA, his war on business, and the confiscatory level of taxes caused the business community to fear to commit capital. John Maynard Keynes said that the "cure to this recession [1930s] is the revival of cheerfulness" (or "animal spirits"), which would cause those with capital to invest. In fact, as World War II approached, America geared up to play its part in that great conflict, and, in the end, it was this huge national engagement which brought the country out of the Depression.

The U.S. – A Social Welfare State?

Currently there are those in Washington who see the government as the primary solution to the current economic problems. Others want to use the current economic crisis to push America toward the model of democratic socialism practiced in Europe. In the European Union, government spending, as a percentage of GDP, has declined from 48% to 47% in the past 10 years. In the U.S., it has jumped from 34% to 40%. Part of this growth in U.S. government spending reflected the emergency intervention of the previous administration last year. However, recent legislation introduced by the current administration makes it clear that far from retreating from greater government spending, they wish to emulate the European approach. The social welfare model, as practiced by many European nations, generally means greater government spending, higher taxes, slower GDP growth, and higher unemployment. Some of the unintended consequences of this approach (especially if taxes are raised in the midst of a very painful economic downturn) might be a long slow economic recovery, modest job growth, high unemployment, higher interest rates caused by a doubling of the U.S. federal debt, a weaker dollar, and higher commodity costs (energy and food). This sounds reminiscent of the stagflation of the U.S. in the 1970s.

Investing in This Secular Bear Market

It is possible that the secular bear market ended in March or that it will end later this year. Often these trends can only be established in retrospect. Stagflation may not even occur this cycle. Conversely, our economic problems may persist for some years. Thus, it is useful to consider some implications of investing should this secular bear market last another five years or more. In the first place, active management, selection of quality stocks and a flexible approach will be critical; passive investing (buying and holding U.S. index funds) will generally produce poor results (as it has from 2000 until now). Secondly, diversification into a very broad range of asset classes may be counterproductive, as certain asset classes will perform much worse than others during a secular bear market. Thirdly, investing in stock markets in emerging countries with robust GDP growth may produce much better results than in the U.S. If the dollar weakens again and is in danger of no longer being the world's main reserve currency, exposure to international markets and commodities (such as gold, oil and minerals) will be important. Timely and selective use of fixed income instruments (such as TIPS) may also be valuable. Finally, exposure to small and mid cap stocks may be helpful, as these asset classes have generally produced better results than large capitalization stocks. At Bradley, Foster & Sargent, Inc., our active management approach has served our clients well, we believe, since our inception in 1994, and we intend to continue this approach during this secular bear market. Moreover, we have been developing our capabilities of managing equities in international markets as well as in the small and mid capitalization sector. Thus, we believe that we are well positioned to help our clients preserve capital in these challenging times and craft investment strategies which may even enable them to navigate profitably through this difficult market.