Bradley, Foster & Sargent, Inc.
Quarterly Market Commentary

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2011 Bear Markets: Both Cyclical and Secular

Rather go to bed supperless than rise in debt.
Benjamin Franklin

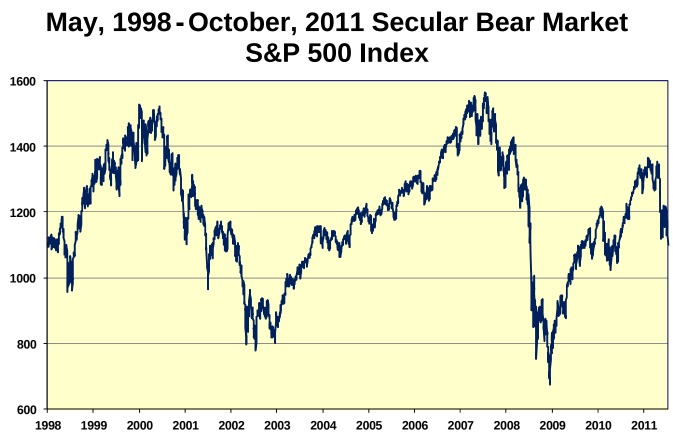
Debt is the fatal disease of republics, the first thing and the mightiest to undermine governments and corrupt the people.
Wendell Phillips

Over the past five months, investors have suffered a wrenching cyclical bear market. On May 2, 2011, the S&P 500 Index hit a 52-week intraday high of 1370. Some investors heeded the time-worn New York Stock Exchange adage of "sell in May and go away." Most investors, however, were sanguine about the stock market, believing that U.S. GDP growth was destined to accelerate to 3% during the second half of the year. In July, all eyes turned to Washington and the debt ceiling negotiations between the White House and Congress. Many investors believed that a compromise would be achieved which would keep the government functioning. And this, in fact, occurred. But then, on July 29, 2011, the Commerce Department reported that GDP growth in the second quarter rose only 1.3% – well below expectations. Even worse, first quarter 2011 GDP growth was revised down from 1.9% to 0.4%. Fast money investors glimpsed the specter of a double-dip recession looming ahead and bailed from the stock market with most of the damage to prices done by August 9th, when the S&P 500 touched 1101 intraday. At that point, buyers re-entered the market in force and drove the market higher for a time. But in September and early October, the growing Greek sovereign debt crisis and the vulnerability of many European banks to default on this debt gave sellers the upper hand again, and the S&P 500 Index touched 1074 intraday on October 4th. The chart below shows the S&P 500 Index rolling over this summer and the subsequent pain as investors endured another cyclical bear market (although stock prices have reversed course recently):

There are numerous definitions of a "bear market." Most market observers agree that a bear market is a drop of 20% or more in key stock market indices over a period ranging from weeks to several years. This summer, the market declined *21.6%,* as indicated in the above chart. This kind of sharp market drop is called a *cyclical bear market,* because it has taken place over a relatively short period of time, compared to the decade-long trends which make up a secular bear (or bull) market. The previous cyclical bear market occurred between October, 2007 and March, 2009 during the financial Panic, when the S&P 500 Index fell 57.7%. It should be noted that the current cyclical bear market may not be over. While stocks already seem inexpensive, some respected market analysts predict a further decline in the S&P 500 to a range of 820-960.

Secular Bear Markets

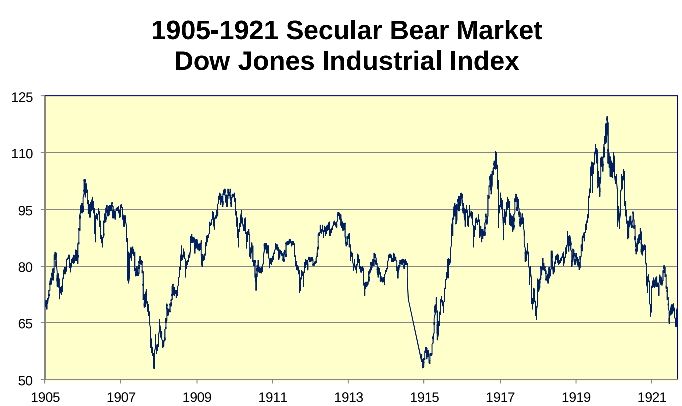
As emotionally wrenching as a cyclical bear market can be, the pain experienced by investors in a *secular bear market* is usually far worse, because a secular bear market lasts much, much longer. A secular bear market is a long-term trend of *10 to 20 years* during which key stock market indices make little or no upward progress. For example, the total return (including dividends reinvested) of the S&P 500 Index for the 11.75-year period from January 1, 2000 through September 30, 2011 was -4.49%. The chart below shows the current 13+ year secular bear market which has so bedeviled investors:



Source: Standard & Poor's

The S&P 500 Index first touched 1100 in May, 1998; several weeks ago, it sliced through the 1100 mark and touched an intraday low of 1074. It is easy to see why the patience of many investors has run out, with many exiting the stock market discouraged by the lack of a positive return over more than a decade.

The U.S. is currently in the midst of the fourth secular bear market since 1900. The first secular bear market of the 20th century lasted from 1905 through 1921. It encompassed the Panic of 1907 (when J.P. Morgan kept the U.S. financial system from collapse), World War I (including a period in 1914 when the N.Y. Stock Exchange was shuttered for trading for six months) and its deflationary aftermath. The chart below tells the story:



Source: Dow Jones

The 1905-1921 secular bear market was followed by a 7-year stretch when the U.S. economy boomed due to the economic policies of Coolidge and Mellon; the Dow Jones tripled during this period. The chart on the next page shows the longest and worst secular bear market of the 20th century:

1929-1949 Secular Bear Market
S&P 500 Index

Source: Standard & Poor's

During the Great Depression, three monetary and fiscal policies caused much of the economic hardship: the Federal Reserve contracted the money supply by one-third, leading to crushing deflation; the Smoot-Hawley tariff did incalculable damage to global trade; and both the Hoover and Roosevelt administrations raised taxes significantly. The market put in a key bottom after the Battle of Midway in May, 1942, but even with the market's average annual return of 9%+ for the remainder of the 1940s, the S&P 500 Index finished 1949 at a lower point than its peak in 1929.

The 16-year period from 1950 through 1965 was a time of remarkable economic growth and a roaring stock market. The S&P 500 Index's total return in this period increased more than *eleven fold*. Then, as night follows day, this halcyon period for stocks was followed by the next secular bear market which started in 1966, when the Dow Jones first touched 1000. This secular bear market lasted *16 years*. The period was punctuated by bad fiscal policies during the Vietnam War, several OPEC oil shocks, Watergate, high inflation, and even higher interest rates. The chart below chronicles this long bear market:

1966-1982 Secular Bear Market
Dow Jones Industrial Average

Source: Dow Jones

One of the reasons for analyzing the history of the U.S. stock market over the last 100 years is to determine if trends and patterns can be observed. And, in fact, there does appear to be a pattern: painful, secular bear markets have invariably been followed by secular bull markets during which investors have profited handsomely. Each secular bear market was brought on and characterized by different factors, but each of the four secular bear markets has several common features. The first is that the stock market reflects human nature, and human nature does not change. There are periods of optimism, exuberance, and greed, when caution is flung to the wind by investors; and there are times of pessimism, fear, and even panic, when investors give up on the U.S. economy and the stock market. During the heady periods of exuberance, share prices are valued at very rich multiples. During times of hardship and pessimism, shares sell at very low valuations (as in 1974 or 1982 when the market multiple was in single digits). Investor psychology plays a major role in the economy and the behavior of the stock market.

A second key factor is that the compression of the stock valuations during a secular bear market comes about because investors become pessimistic about the national or international macroeconomic and political conditions of the era. These often involve wars but also arise from conditions leading to inflation (the OPEC cartel in the 1970s), deflation (the Great Depression), or the current excessive public debt in many developed countries. Sometimes global or external factors leave a government with little room to maneuver. But more often, the wrong ideas combined with poor leadership lead to economic hardship. Yet once the ship of state rights itself and the right course is charted, a democratic capitalist economy resuscitates itself, and the stock market with it. Policies have consequences. The table below shows the strong growth of corporate earnings over the last 20 years as well as the fickleness of investors, valuing shares with heady exuberance in 1999 and with glum pessimism at the moment:

Year	S&P Operating Earnings	S&P 500 Index Year-end Price	P/E Ratio
1991	$19.30	417	21.6
1999	$51.68	1469	28.4
2007	$82.54	1468	17.8
2011	$97.98E	1131 (9/30/11)	11.5

During this 20-year period, the earnings of top U.S. corporations have increased almost fivefold – an average annual growth rate of 8.5%. At the same time, the market's P/E ratio has almost halved and dropped nearly 60% since 1999. If and when the U.S. begins to solve its macroeconomic problems, investors who persevere will likely enjoy excellent returns when the next secular bull market gets underway and P/E ratios expand.

Conclusion

No one knows when the current *13+ year secular bear market* will end. But a new secular bull market will commence not when all U.S. economic problems have been solved but rather when investors see clearly that key economic problems are being addressed at the margin by a U.S. political leadership committed to persevere with the right policies. The key factors which will influence the course of the current *cyclical bear market* are: decisive steps to restructure Greek sovereign debt, the recapitalization (or nationalization) of key European banks which own the troubled debt, the support of key European governments to stay the course of austerity, clear indications that the U.S. banking system will not suffer from a default on European sovereign debt, and the reacceleration of the U.S. economy (or at least investor confidence that the U.S. economy will not begin to contract). During this difficult period, we at Bradley, Foster & Sargent, Inc. believe that investors need to emphasize capital preservation, choose active investment management rather than passive index funds, and underweight cyclical industries. Finally, investors need to overweight quality multinational companies with strong brands, excellent balance sheets, strong cash flow, and a record of paying a growing stream of dividends. Most of these companies have shown positive returns year-to-date, and we believe that they will continue to hold up well in this difficult environment. And, yes, this secular bear market will end!