Bull, Bear or…
Neither?

Canadian MoneySaver
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INVESTMENT STRATEGISTS at Merrill Lynch continue to be bullish on equity markets. Their targets for the TSE 300 and S&P 500 are 11,000 and 1720 respectively.

Interestingly, since 1998, it has become increasingly evident that North American stock markets have taken on a change in character. We believe that this change could have a profound effect upon the returns that buy-and-hold investors can expect over the next several years. The current market environment bears resemblance to the sixteen-year period between 1966 and 1983. During that period, the major market averages traded more or less sideways. Observe the chart in Figure 1 of the Dow Jones Industrial Average, which illustrates the period from 1970 to 1983.

Figure 1

The Dow was in a defined range, which was capped at 1000 on the upside. Aside from dividends, buy-and-hold investors would have realized no net gains in their portfolios. That directionless market probably tested the ire of even the stodgiest long-term investor. Some may have seriously questioned their convictions even to the point of capitulation (selling out at or near the bottom in complete frustration).

After the Dow broke out of the long-term trading range in 1983, stocks began the greatest ascent in stock market history. You could easily draw neat and tidy upward-sloping trendlines following the Dow as the bull market progressed. Now, observe Figure 2, which illustrates the Dow since 1990.

Figure 2

As you can see, corrections and sideways periods tended to be short-lived (less than one year). The market would touch the trendline during the correction and then advance. This pattern of successive market advances punctuated by short-lived corrections appears to have changed. For two years, major U.S. indices have trended sideways. It seems that we have entered another prolonged non-trending period that has actually pierced the previously unbroken trendline, with an upper range of 11,500 and a lower range of 9800. Currently, we are at the lower end of that range. Moreover, note the higher volatility since 1998, again similar to the large swings seen in the 1966-1983 period. Could the current sideways market become that long standing again? This is a difficult call to make; however, it would certainly seem to be the most extreme case scenario.

Investors using a buy-and-hold strategy on a diversified U.S. blue chip stock portfolio since early 1999 have had nominal returns. There appears to have been no positive or negative trend to the U.S. markets over this period of time, which could be the rule rather than the exception for some time to come. But what about our own TSE 300? While it is difficult to offer conclusive evidence, we believe that the TSE 300 ex- Nortel Networks (i.e. the TSE 299) would have had a similar pattern as the Dow since early 1999. Up until September, if you didn't own Nortel, you were likely to underperform the TSE 300. In other words, the majority of the most heavily weighted Canadian blue chips appear to have been trading in a sideways range. From our personal observations, most investors are still operating within a buy-and-hold mindset, believing the broader markets will resume their steady climb characteristic of the 1982-1998 period. This may be more wishful thinking than reality. As we tend to believe that this transition from an advancing to a sideways market may be more entrenched than many would like to believe, those investors who are still in the buy-and-hold mode may become increasingly disenchanted by the potentially lower returns offered by stocks going forward. Does this mean that we have entered into a bear market? Actually, we believe that the bull market is still alive and well. Perhaps, we are witnessing more of a ratcheting down in the economy to more sustainable and historically normal rates and a return to more reasonable expectations on the markets.

The period 1999/2000 was one of tight job markets, economic prosperity and the fear of "falling behind" the new "e-Economy". Overheated corporate and retail spending led to stock market and consumer inflation, mainly within the technology sector at a cost to more traditional "bricks and mortar" companies. Now that growth and demand expectations are rapidly cooling, along with the economy in general, we have witnessed investor expectations abruptly turn anti-tech with the NASDAQ down an eye popping 50% from its spring highs. With these excesses (including bloated tech-related inventories) being worked out of the system, it is likely that more sustainable, albeit muted, economic growth lies ahead. This is *not* the kind of stuff that a bear market is typically made of. Call it a "reality check market" instead. Nonetheless, slower growth and, therefore, more moderate price/earnings multiples will more than likely curtail the chance of a new multi-year market advance beginning for some time.

Although the bulk of negativity has been factored into growth stocks, lingering high valuations (notably in certain technology, health care and telecom stocks) and a lack of significant new capital inflow may keep many leading stocks “range bound” (more on this below). From a soft-landing perspective, the 1994/1995 period may be somewhat analogous to the current backdrop.

From our study of longer-term market trends, we are of the opinion that the previously advancing market may continue to pause for a while. Typically, major market trends seem to last six years or longer. At this time, we appear two years into a sideways trading pattern. From a fundamental perspective, we believe that this pattern may continue for an extended period due to the following factors:

- Stock and bond markets are primarily driven by interest rates. While Federal Reserve Board Chairman, Alan Greenspan may ease rates in the short term, the long-term secular decline in interest rates that began in 1981/1982 (when interest rates fell from over 18% to 5%) seems to be nearing an end.

- Over the past five years, investors have flocked to the highest quality, largest stocks on the market. It should come as no surprise that many S&P bellwethers still trade at the upper end of their historical price to earnings ratios, thus potentially limiting any significant breakouts to new highs. It may take several years of sideways stock prices for earnings to play “catch up” with prices in order to allow the stocks to move higher.

- Over the last two decades, money has been flowing out of fixed income securities (i.e. GICs, term deposits, T-bills, etc.) and into the stock market. This immense shift into equity markets has ebbed significantly in recent times. A decline in “liquidity” or net cash flow into the market going forward may both limit equity price growth and favour higher volatility. We wonder if the story about baby boomers driving the bull market for years to come makes any sense at all or is just so much hype.

- In recent years, access to financial information from businesses, analysts and the media has mushroomed to gigantic proportions. Now, the floodgates have burst open with the advent of the Internet and sweeping reforms to U.S. corporate disclosure laws. These two events now allow virtually any investor instantaneous availability to a vast array of opinions and date, surprisingly at next to no cost. The percentage of investors who are committing at least a portion of their wealth online has grown nearly exponentially. From our experience, many of these investors are story-oriented and emotionally driven. Their short-term investment habits have and will likely to foster record levels of volatility.

We would characterize the current market environment as *"stealth bull market"*. Technical analyst, Ralph Acampora the originator of this term, has noted that money does not appear to be leaving the market, as is common in a bear trend. It is simply churning from sector to sector, from stock to stock. For example, we have recently witnessed a shift from technology, media and telecom stocks to financials, utilities, pipelines, consumer staples and energy. This is not to say that no new money is entering the market (or invested money exiting the market)—it likely is, albeit at a much more subdued rate. The key to a winning approach in this type of rotational market may be for the investor to rotate with the market and invest in only the *best behaved* sectors and stocks at any given time (those with superior relative strength). Subsequently, investors should be prepared to shift to the next market leaders as sentiment changes. In a stealth bull market, our stock discipline tips in favour of *technical (trend) analysis*, whereas in a bull market it would tend to be equally, if not more important, to apply *fundamental (business) analysis*.

If we are truly correct about the current market behavior, then an investor should become far more proactive in rotating between sectors and stocks if he is to enjoy better-than-average results. The question is: How does one know which sectors to own and which not to own? We believe that studying the technical trends and comparative relative strength of the various sectors and stocks will provide important clues to help answer this question. For our clients, we employ technical analysis software and monitor the main Canadian and U.S. sectors for those demonstrating superior strength with respect to their relative indices (TSE 300 or S&P 500).

Sectors beginning to turn up in strength are likely seeing money rotate into them, which sectors beginning to show declining relative strength are likely beginning the process of a rotation out. Quite clearly money was rotating out of the financial sector during 1999 while simultaneously rotating into metals and minerals. This year, however, the roles reversed, as money has appeared to be rotating out of metals and minerals and into financials. More recently, there has been a rather dramatic rotation out of technology, media and telecom into consumer staple, financials, utilities and basic industry sectors. Timing has been critical for most sectors over the past two years! Even “sacred cow” stalwart stocks such as Proctor & Gamble and Microsoft have descended through multi-year trendlines for the first time in recent memory. Is any stock truly immune to this heightened volatility? We honestly doubt it.

We believe that one of the greatest time wasters is trying to decide whether we are in a “bull” or a “bear” market. Furthermore, the question of whether to be a “value” or “growth” investor may be losing its significance. The reality is that none of these opinions alone truly matter. The investor who will profit in a stealth bull will be the one who is willing to make both buy *and* sell decisions.