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Stash your cash away, the bear's here to stay

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The Australian sharemarket has officially begun the third and final stage of a secular bear market that kicked off on November 1, 2007. In the universally acknowledged first leg, the All Ordinaries Index went on a gut-wrenching death spiral that was triggered by the global financial crisis in 2008. During that 16-month period, the index plunged 54 per cent, the second worst continuous decline ever experienced by the local share market. The second leg of the bear market came undetected when the All Ords started an unlikely rally in March 2009 that catapulted the index 50 per cent higher in just 13 months. This was followed by one year of the index grinding sideways in a tight range until April 2011 when it went into its most recent decline. Since then it has fallen about 10 per cent and this should mark the beginning of the third and final stage of the secular bear market.

That all sounds exciting but investors should keep their wallets firmly in their back pocket. The final down leg of a secular bear market is traditionally long and drawn out and can be best described as death by a thousand cuts. This is vastly different to the first jolting stage that was symbolised by investors dumping stocks on the back of margin calls. The final slash of the bear's claw should be wielded in the second half of 2012. It will be at this stage that investor sentiment will be so pulverised that many will believe you can never make a decent return out of the share market ever again. And that is when the new secular bull market will be in its nascent stages. This new bull market should unfold over more than a decade and could possibly last 20 years, delivering a return on the All Ordinaries Accumulation Index of about 800 per cent.

There is only one certainty about predicting the future and that is you will never be completely correct. However, my analysis is based on closely examining previous bear markets which I have found highly instructive since those heady days of late 2007. Unfortunately, market experts who have relied on valuations for both the overall market and individual stocks have proven to be sidestepped by the pervasive macroeconomic events. It is difficult to argue that current company valuations, especially in the Australian industrial sector, are anything but cheap. However, this is unlikely to prove the catalyst to a new bull market any time soon. History is by far the best guide. As the legendary investor, Sir John Templeton, stated, "The four most dangerous words in investing are 'this time it's different'."

Before anyone delves into the history of bear markets, they should differentiate between a standard bear market and a secular one. A standard bear market is defined as a decline of 20 per cent from the peak. In the US, this has happened 15 times over the past 110 years with an average decline of 39 per cent over approximately 20 months. Strangely, some of these 20 per cent-plus falls have happened during major bull markets such as the October 1987 crash in which the Dow Jones fell 36 per cent in two months before powering to a new high in a short period of time.

Secular bear markets, though, are completely different. They occur when investors fail to make a return for protracted periods of at least a decade and possibly up to 30 years. America has only experienced two of these during the 20th century - from 1929 to 1942 and again from 1966 to 1982. A third secular bear market kicked off in April 2000 when the technology bubble burst and the market declined more than 45 per cent over 30 months. Investors who entered the US market just before April 2000 are still under water, 11 years later, to the tune of 15 per cent. In real terms, with inflation taken into the account, those same investors are down about 35 per cent.

It sounds awful but if the S&P 500 index rallied through the March 2000 high in the near term, it would be the shortest secular bear market during the past 110 years. In the previous two secular bear markets, it took 25 years

and 16 years respectively to march into record territory. Given the scale of economic woes and the extent of the bull market from 1982 to 2000, it seems highly improbable the US market will move higher from here.

History tells us the US market, which still represents 30 per cent of world equity markets, will experience another 20 per cent-plus decline over the next year or so, before it can reasonably be expected to start a lasting rally. At a minimum, the S&P 500 index should not surpass its March 2000 high until at least 2016, representing 16 years of secular pain. If, therefore, the final decline in this secular bear market lasts until the end of 2012, it will take just under four years to rally to a record high.

What does all this mean for Australia? Historically, the Australian share market has been more difficult to assess than the US one, because of its narrow nature up until about 1970.

Australian shares have been subject to two secular bear markets since 1969. The first ran from 1969 to 1979 with the ultimate bottom being in September 1974. This period was symbolised by the end of a monumental resources boom and the arrival of stagflation in the Western world. Stagflation is the undesirable combination of low-to-no economic growth and above-trend inflation. The market lost about 50 per cent of its value over the five years from 1969 and took about another five years to hit a record high. If you take inflation into account, investors who dived into the market at its peak in 1969 did not recoup the value of their investment until 1985. That is very long time especially if you are a retiree.

The second secular bear market was from 1987 to 1995. This was different to the 1970s because after the crash the market spent the best part of five years going nowhere, before taking off in late 1992. It wasn't until 1995 that the index eclipsed the previous record set in September 1987. With inflation in the mix, investors were in the red for 10 years.

So that brings us back to the current mess. A secular bear market takes time. There has been a lot of commentary in recent times about how it takes, on an average, four years to reach the old high after a bear market. This analysis fails to recognise the different types of bear markets and gives no recognition to the existence of a painful secular one.

Strategists around the globe are frantically trying to justify their market direction calls. When the markets were charging higher in the second half of 2010, most forecasts were bullish, based upon economic recovery and low interest rates. Move forward six months and these predictions have become pessimistic with the European and US economies slowing on the back of Himalayan-size debt burdens. This waxing and waning is all part of a secular bear market. There are rallies and there are 20 per cent-plus declines, and no one seems to get it exactly right. One factor that never changes though, is that we need time and that is what the market is buying until the big economies of the world find a path out of the current mess. Let's hope my prediction of the start of a new secular bull market arriving in 2013 is not overly optimistic.

This is Matthew Kidman's final week as fund manager at Wilson Asset Management. He is the author of *Bulls, Bears and a Croupier*.

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