An Anatomy of Bear Markets

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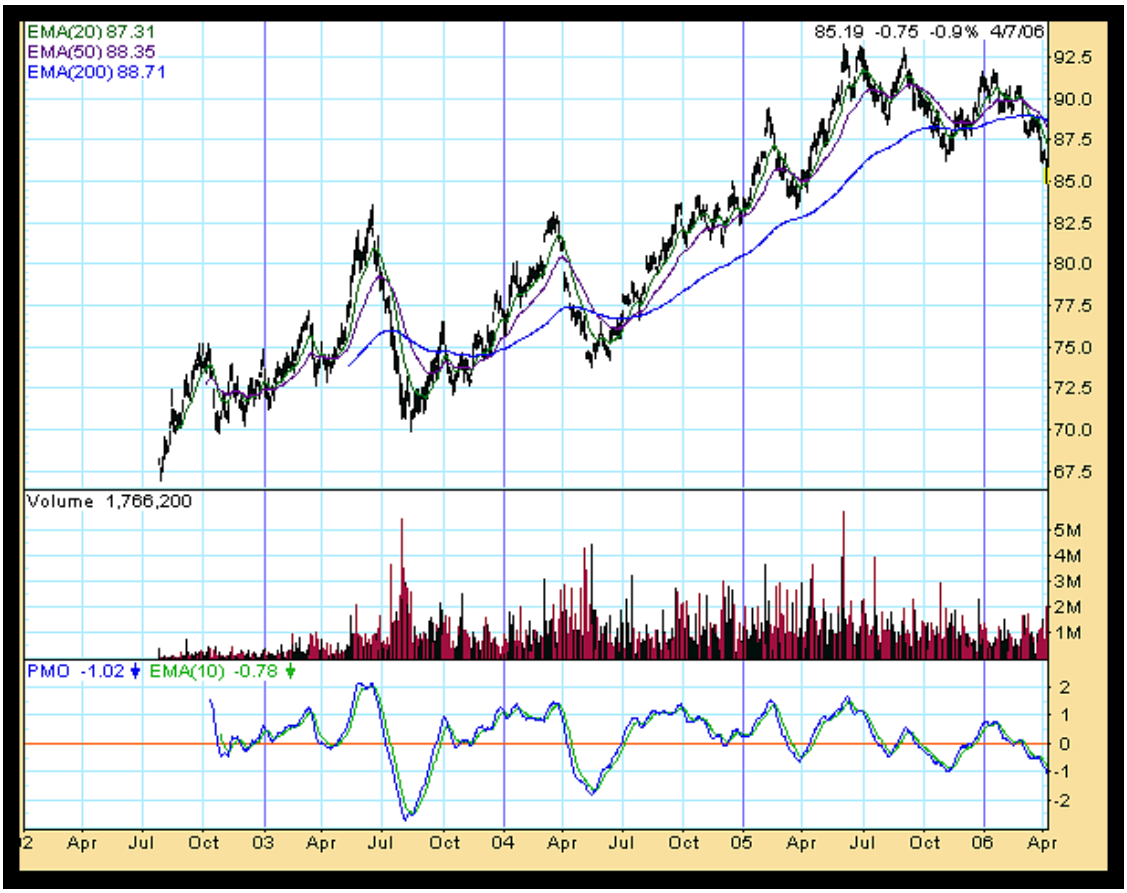
Today, I wish to address the subject of bull and bear markets. This cyclical movement in asset prices, investors will call, when prices are rising, "bull markets" and when prices are declining "bear markets". On the surface this seems simple to understand. The Dow goes up, it's a "bull market", the Dow goes down it's a "bear market". But, in reality, bull and bear markets are far more complex. Let's assume we have just five asset classes. Real estate, stocks, bonds, cash, and gold (or a hard currency for which money supply growth is kept at the rate of real GDP growth leading to stable prices). At present, it is clear that the Fed is printing money. So, all asset prices except bonds will rise in value. But, some asset prices will increase more than others. Since October 2002, the Dow Jones has rallied in US dollar terms, but against gold it has depreciated (see figure 1).

Figure 1: Dow Jones Industrial compared to Gold, 1996 – 2006

Source: www.decisionpoint.com

So, we can say that, yes, the Dow has been in a bull market since October 2002 in dollar terms, but it has been in a bear market in gold terms. This is an important point to understand. In case we should experience continuous monetary inflation, which could lift, over time, all asset prices such as stocks, real estate, and commodities, some asset classes will increase more in value than others. This means that some asset classes while rising in value could deflate against other asset classes, such as happened with the Dow against gold since year 2000. I have pointed out in earlier reports that since 2002, all asset prices rose in value. But recently, some diverging performances emerged. Bonds started to decline and seem to be on the verge of a significant long term break down (see figure 2).

Figure 2: 20 Year Treasury Bond Fund (Leh) iShare (TLT), 2003 -2006

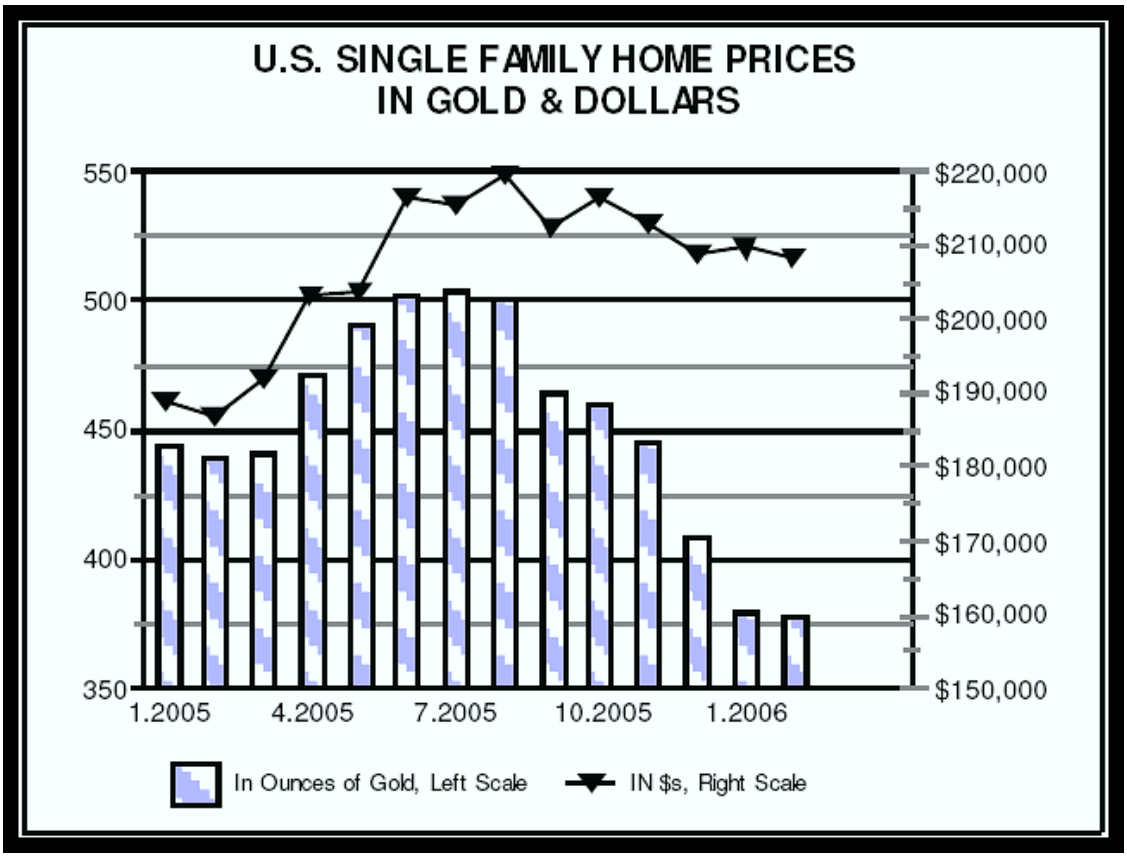


Source: www.decisionpoint.com

I have also mentioned in earlier reports that, in times of monetary and credit inflation, such as we have now in the US, bonds are the worst possible long term investment.

Another asset class, which has recently begun to depreciate against gold are home prices (see figure 3)

Figure 3: US Home Prices in US dollars and in Gold



Source: The Value Gold Report

As can be seen from figure 3, since last summer, home prices while only declining moderately in dollar terms, have declined significantly in terms of gold. So, whereas it took over 500 ounces of gold to buy a typical house in the US last summer, now, it only takes around 380 ounces of gold. In other

words, home prices have declined over the last 9 months by 25% against the price of gold!

What I really want every reader to understand is that bull and bear markets are extremely complex and an asset class, which seems to be in a bull market may not necessary be in a bull market when compared to a hard currency such as gold. In this respect the following is also important to consider.

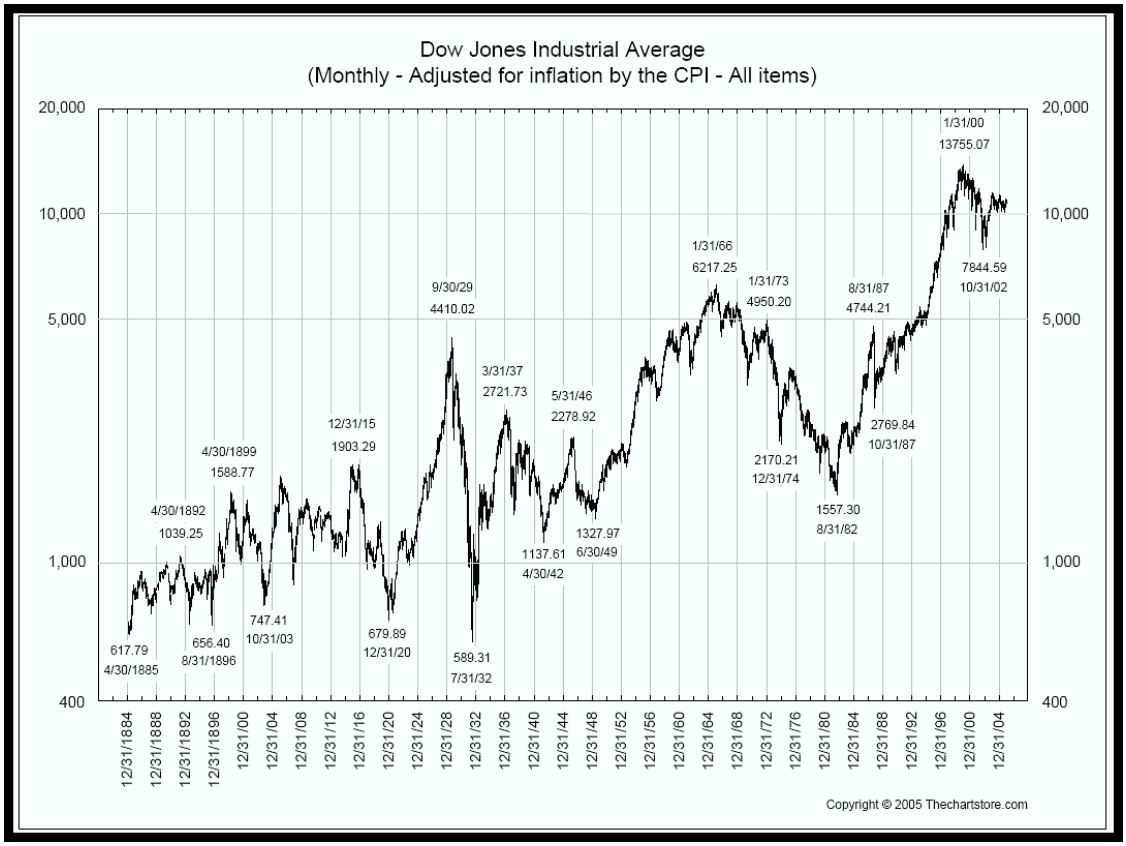
Conventional wisdom has it that a true market bottom, which offers a once-in-a-lifetime buying opportunities, only occurs after a devastating bear market. In this context, the following severe market declines usually spring to investors' minds: the 1929–1932 bear market in US equities; the collapse in the US bond market between 1970 and 1981, when yields on 30-year US Treasuries rose from 6% in 1970 to 15.84% in September 1981 and sent bond prices tumbling; the 1973–1974 Hong Kong stock bear market, which brought the Hang Seng Index down by 90% to its December 1974 low at 150; the great sugar bear market, which sent prices down from 70 cents per pound in 1973 to 2.5 cents in 1985; or the Japanese bear market post-1989, when the Nikkei dropped from 39,000 to less than 8,000 in April 2003. Moreover, major market lows are associated by investors with total despair and panic among market participants, depression in the asset class that was subjected to the bear market, bankruptcies in that sector, and overwhelming negative sentiment.

But, as Russell Napier shows in his recently published book *Anatomy of the Bear — Learning from Wall Street's Four Great Bottoms* the key element in undervaluation can also be a period of time "when the advance in stock prices has failed to keep pace with the economic and earnings growth" within the system (The book – an excellent read - is available from Amazon.com or from CLSA directly. Contact victoria.tang@clsa.com).

Napier shows, for instance, that at the market low in 1921 the Dow Jones Industrial Average was no higher than it had been in 1899 — 22 years earlier — while nominal GDP had increased by 383% and real GDP by 88%! Similarly, by August 1982, the Dow Jones Industrial Average was no higher than it had been in April 1964, and was down by 70% in real or inflation-adjusted terms. According to Napier, August 1982 represented the fourth-best buying opportunity for US equities in the last century, aside from 1921, 1932, and 1949 (see figure 4). **The important message one might take from Napier's book is that it usually takes a long time — about 14 years — for stocks to travel from overvaluation to undervaluation, and that the nominal low in stock prices isn't always the best time to buy equities**. What is more important is the real level of equity prices and various valuation parameters that indicate deep undervaluation. Thus, while

the Dow Jones bottomed out on December 9, 1974 at 570, and stood at 769 at its August 9, 1982 low, in real terms the Dow had lost another 15% since the 1974 low (see figure 4).

Figure 4: Dow Jones Industrial Average in Real Terms, 1884 - 2006



Source: Ron Griess, www.Thechartstore.com

I am mentioning this because it is possible that the October 2002 lows for the US stock indices will hold in nominal terms. However, as I have shown above, the Dow has been declining in gold terms since 2000 (see figure 1) and is, in my opinion, likely to continue to do so for many years.

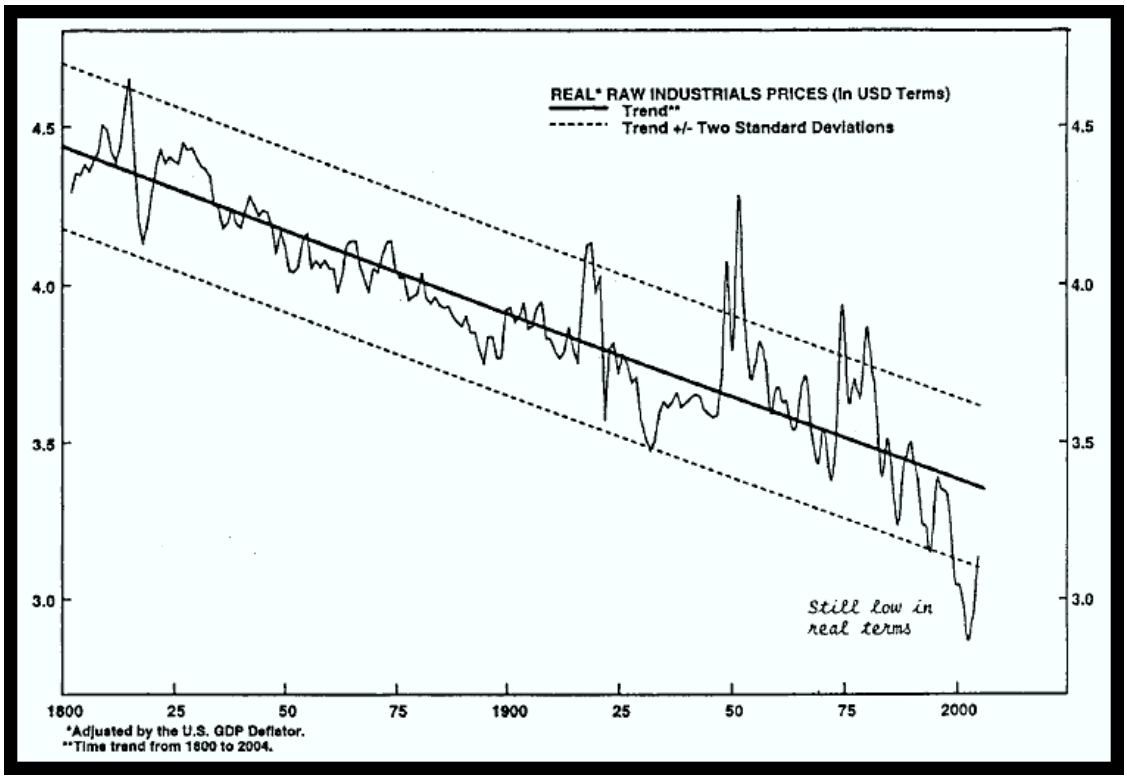
As a side, Russell Napier has filled a void with *Anatomy of the Bear*, since, to my knowledge, it is the first book to trace the swings from undervaluation to overvaluation and back to undervaluation, of US stock prices over the past 100 years. The book also provides much food for

thought. If equity prices swing back and forth between overvaluation and undervaluation, other asset markets such as real estate, commodities, and bonds will do the same. Thus, I suppose that, in the same way that US bonds were grossly overvalued in the 1940s, Japanese bonds were grossly overvalued in June 2003, when the yield on JGBs had declined to less than 0.50%. At the same time, the April 2003 low for the Nikkei Index at less than 8,000 may have been the best buying opportunity in Japan of this generation. In fact, the 2003 lows in Japanese equity prices and interest rates have similarities to the 1940s' lows in US equities and interest rates. After the 1940s, US stocks rallied into 1973, but bond prices collapsed into 1981. Similarly, the stock market rally in Japan, which began in 2003, could last for many years and be accompanied by a significant bear market in Japanese bonds, which would drive local institutions and Japanese households out of their overweight bond and cash positions, which benefited during the 1990s' deflation, and into equities and real estate. Moreover, if, as Napier explains, 1921, 1932, 1949, and 1982 provided outstanding buying opportunities for achieving subsequent high returns that tended to last for a minimum of eight years (1921–1929), but usually for much longer (1982–2000), then I suppose that — taking the late April 2003 low of Japanese equities as a generational low — the bull market in Japanese equities could easily last until at least 2010 or even longer, and in the process significantly outperform US equities.

Another lesson from Napier's book could very well be that other Asian equity markets, relative to other assets, remain grossly undervalued despite their post-1998 recovery. After all, many Asian stock markets, whether in US dollar terms or in real terms, are still down by more than 50% from the highs reached between 1990 and 1994.

Lastly, if, as Napier outlines, it takes about 14 years for equities to make the journey from overvaluation to undervaluation, the severity of the commodities bear market from 1980 to the turn of the millennium — about 20 years — is evident. Put into the proper perspective, in real terms (inflation-adjusted) commodity prices were, in the 1998–2001 period, at the lowest level in the history of capitalism (see Figure 5). And, although I expect some industrial commodity prices will suffer from a significant phase of profit taking in 2006, given the fact that commodity bull markets tend to last anywhere from 20 to 30 years, we may just be at the beginning of an extended rise in the price of natural resources.

Figure 5: Real Raw Industrial Prices, 1800 -2006



Source: The Bank Credit Analyst

There is another point I should like to add to Russell Napier's excellent study, which I strongly recommend investors to read. In a world of rapid monetary and credit expansion, an undervaluation of the Dow Jones might occur, with a Dow Jones at 36,000, 40,000, or 100,000 or more — a stock price level that was predicted by several analysts in 1999. How so?

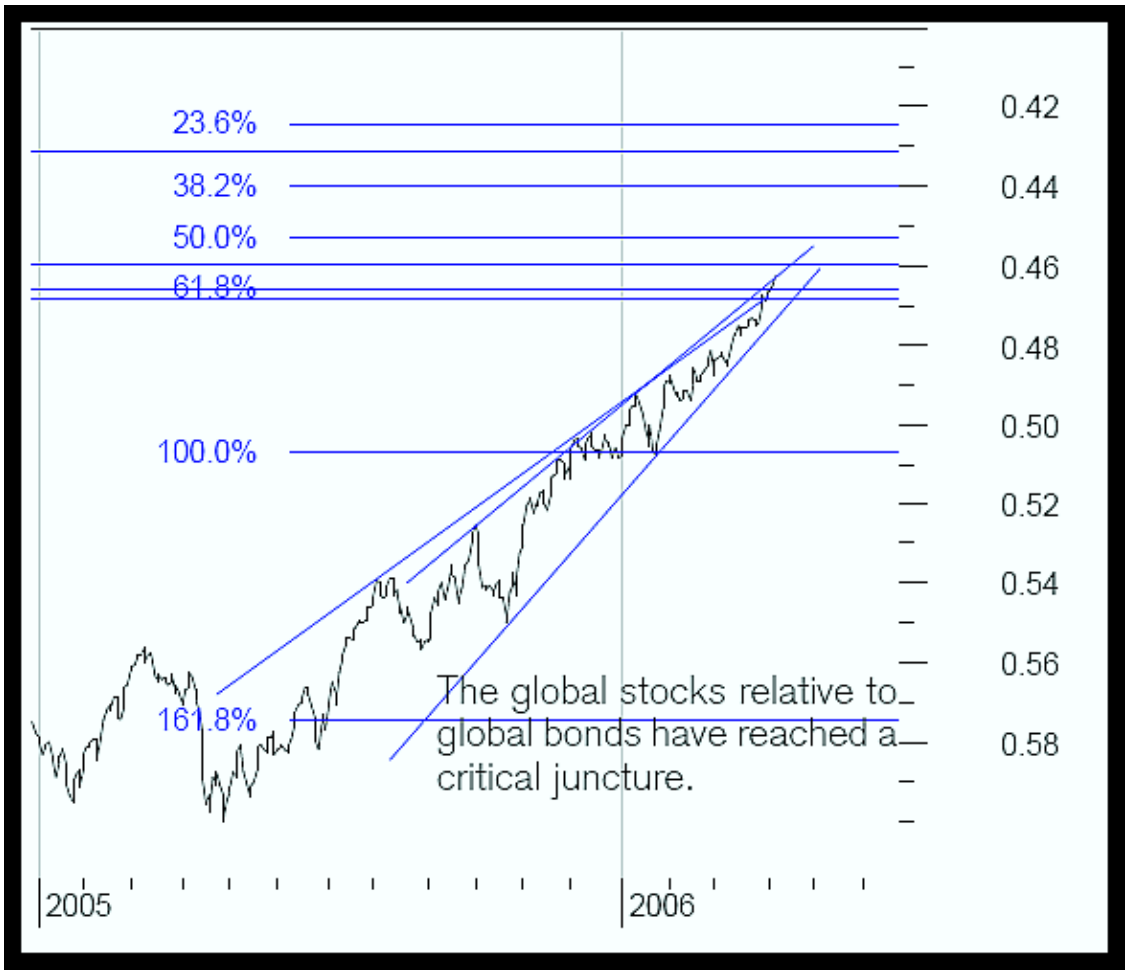
At present, the Dow is at around 11,000 and the price of gold is at $590. Let us assume that, as a result of Mr. Bernanke's more efficient paper money printing machine (incidentally, a machine that has been in operation since the formation of the Federal Reserve Board in 1913 and which accounts for the dollar's 92% loss in purchasing power since then), the Dow Jones rises to 36,000 in the next few years. (It won't take another 100 years for the US dollar to lose another 92% of its purchasing power; more likely is 10 to 20 years.) If this were the case, the price of gold could rise from $550 to $3,600, which would bring down the Dow/gold ratio from currently about 19 to 10; or, in an extreme case, gold could rise to $36,000, which would bring down the Dow/gold ratio to only 1 (as was the case in 1932 and in 1980)

Thus, in nominal terms, the Dow would have trebled from the present level, but lost significantly in real terms — a possibility that I regard as very likely. In this respect, we shouldn't forget that during the German hyperinflation period between 1919 and 1923, share prices rose sharply in paper mark terms but tumbled in dollar terms (then a strong currency), because the rate of the paper mark depreciation against the US dollar exceeded the local share appreciation. Thus, by October 1922, an index of shares in local paper mark terms had increased from 100 in 1918 to 171 billion, while in dollar terms the same index had dropped from 100 to 2.72! Needless to say, the 1918–1923 German hyperinflation was devastating for paper mark cash and bond holders.

Now, I am not necessarily predicting that we shall soon experience hyperinflation rates in the US, but when the Dow Jones and the US housing market will decline by 10%, it is very probable that Mr. Bernanke will put the money printing presses into high gear in order to fight asset deflation. So, US asset prices including homes, stocks and bonds could depreciate in real terms and against precious metals.

Still, as I indicated last month, aside from bonds, all stock and commodity markets seem to be now overbought and vulnerable to a sharp correction. In fact, whereas I am extremely negative about bonds in the long term, I believe that for the next three months or so, bonds could actually outperform equities and also commodities. From figure 6, we can see that equities have formed a rising wedge against bonds since 2005. More often than not, a rising wedge leads to a sharp downside reversals. This would not necessarily imply that bond prices will rally much, but the wedge might be broken on the downside by a sharp downturn in equities.

Figure 6: Global Stocks relative to Global Bonds, 2005 – 2006



Source: Rolf Bertschi, www.credit-suisse.com/techresearch

For this reason, my advice remains to be extremely defensive. Most asset markets including stocks and commodities are extremely overbought, and there is far too much speculation in all investment markets. **Therefore, severe downside volatility, also in precious metals, should not be surprising in the period directly ahead.**