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Bull in the Box?

Richard Hoey was on CNBC this morning and I understood him to say that we have begun an "old fashioned" Bull Market. Mr. Hoey is an excellent technical analyst and an interesting and persuasive speaker. Essentially, he feels the market has bottomed in July and successfully tested this bottom in October. The "old fashioned" part of the argument applies that we do not return to the torrid pace of returns on equities that we enjoyed in the late 1990's, but that we have started a trend of positive returns that mirror the somewhat muted, but real gains in corporate earnings that have begun and should accelerate through next year and beyond.

Another excellent market analyst, Richard Russell disagrees. Russell's weekly letter is based on the time honored Dow Theory, and he remains firmly convinced that the market has not seen its lows. Mr. Russell always has a visual depiction of his position in his letters – a box in which the animalistic bent of his opinion on the market is ensconced. There remains a snarling large bear in the box. His thesis is that the prolonged Bull market must be corrected by a very protracted Bear and a valuation level that results in dividend yields on stocks being higher than bond yields. Certainly that would be more consistent with past Bear market bottoms.

Both Richards do fine work. Ultimately, Richard Russell may prove to be right. But, right now I lean a bit more towards Mr. Hoey's point of view. The economy is growing again, reported earnings by most companies are rising significantly from levels a year ago. Monetary and soon to be fiscal policy are quite stimulative. Barring another successful terrorist attack, there will not be a double dip in economic activity.

It is certainly true that valuation levels on current earnings are extremely high, but they are always so at bear market bottoms. But companies have been downsizing for a couple of years now. Any uptick in revenues will largely go straight to profits. The leverage on S&P 500 profits from improving economic growth will be greater than we think. So, I think we have begun the upcycle for profits. That ultimately determines the outcome for stocks.

Also, this will be the third year in a row of stocks to have suffered negative returns. It is now seven years since the S&P 500 has outperformed high quality intermediate bonds. There are both extreme periods in the history of the performance of the capital market. There is serious talk in Washington about reforming the taxation of dividends which is why the current dividend yield is so low.

Richard Russell is the most objective technical analyst I know. He responds to what the market tells him. He put the Bear in the box well before the final peaks in the averages. My guess is that he will have to put the Bull in the box before the end of 2003, well after the market has bottomed.

Having said all that, I must add that returns on stocks going forward will be subpar versus recent expectations. When the "risk free" five year Treasury yields less than 3%, it implies a return of stocks of 5 –10% at best. That is what we would expect for next year, which in our estimation will be the first year in four in which stocks have a positive return.

In addition we would not be surprised that the stock market has its usual February/March swoon. It is already up 20% of the October lows, and there is a good chance that it will be up 30% before this rally is finished. A sell off in early Spring would certainly not be inconsistent with a longer term more positive view on stocks.

-Robert C. Davis, CFA
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