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Second Longest Bull Market Since WWII. How Will it End?

Executive Summary

- The S&P 500 is currently in its second longest bull market since WWII in terms of both magnitude and duration.
- Various *historically-reliable* measures of market valuation are indicating returns in U.S. stocks over the next decade may be about half their historical averages or less.
- It's reasonable to expect at least a 40%-50% decline in U.S. stocks during the "bear" phase of this cycle. The bear phase will complete the current market cycle that began in March of 2009 (each market cycle begins with a bull phase and ends with a bear phase). The challenge, of course, is not knowing when the bull phase will end as we'll only know well after it's topped out.

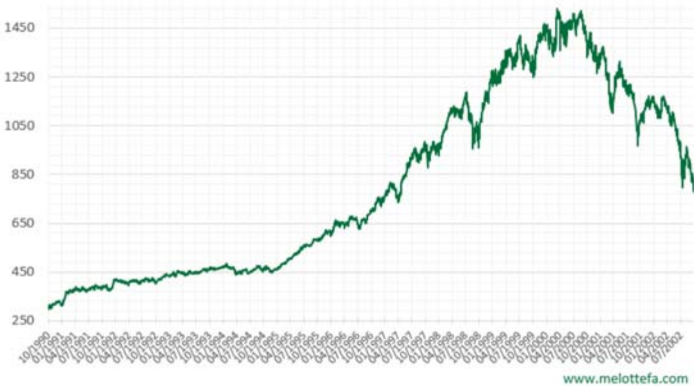
Commentary

Don't look now, but the U.S. stock market is in its second longest bull market since WWII. As of January 12th, the bull market is aged over 7 years and 10 months. The S&P 500 is now 236% higher than it was on its March 9th, 2009 closing low. A chart depicting this period is provided below.

Second Longest Bull Market Since WWII...

The longest bull market occurred between October 1990 and March 2000 (9 years and 5 months) when the S&P 500 climbed over 400% (excluding dividends). Below is a chart showing that full market cycle, which ended in October 2002. Notice that by the time the cycle ended in October of 2002 the S&P 500 was trading about 50% lower than its peak... the same level as April 1997, or 5 1/2 years earlier!

You might also notice that during the bear phase there were a moments of sharp reversals and strong returns, which is not abnormal for a bear phase. In fact, brief periods of positive returns are typical in bear markets just as corrections are common in bull markets. These sharp v-shaped reversals are like head fakes that cause investors to jump in again in anticipation of the beginning of a new bull market only to fizzle away as the market resumes its march lower. This is why market timing is impossible.



So what does this mean for the market going forward? Well, truthfully, not much on its own. The longest bull market in history lasted over 9 years and experienced even more impressive returns while there have been much shorter bull markets as well. So neither duration nor magnitude of a bull market tells us much about when it may end. What is far more important, however, are market *valuations*.

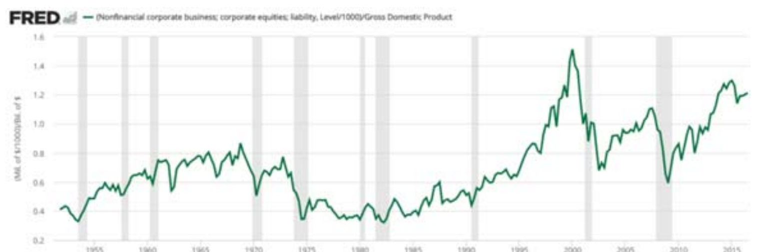
Shiller PE

The Shiller PE ratio has historically been a reliable indicator of subsequent ten-year market returns. This measure indicates **we are currently experiencing the third most extreme valuation going all the way back to 1900!** In other words, current valuations have been exceeded only by the Great Depression and the Dot-Com Bubble. It may not feel like we're in such rare territory, however, because the U.S. stock market has spent the majority of the last 20+ years in this excessively valued territory.

The implications for the S&P 500 are anemic returns over the next ten years of around 4%... roughly half the historical average.

Market Capitalization/ GDP

Market Cap/ GDP, data sourced from the Federal Reserve Economic Database, is Warren Buffett's favorite valuation measure according to a comment he made in a 2001 Fortune interview. The chart below goes back to the early-50s and is reflecting the second-highest valued market over that period. *Shaded bars represent recessions.*



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Dr. John Hussman has been performing extensive valuation work over the last couple decades, and he has also found Market Cap/ GDP to be one of the most reliable predictors of market returns. In Dr. Hussman's December 19th commentary, "Red Flags Waving," he reviews Market Cap/ GDP and what it may be signaling for S&P 500 returns over the next twelve years.

"...valuations are consistent with expectations of S&P 500 nominal total returns averaging scarcely 1% annually over the coming 12-year horizon."

Given the fact that 10-year Treasuries are yielding around 2.4%, his expectation is that U.S. bonds will actually outperform U.S. stocks over the next twelve years on both an absolute and risk-adjusted basis...interesting.

So combining Shiller PE and Market Cap/ GDP we're looking at a potential return range on the S&P 500 of 1%-4% annualized.

Conclusion

It's safe to say that these historically-reliable valuation metrics are predicting returns that fall far short of historical averages over the next decade. However, this is not to say the market will produce consistently low returns over the next ten years but more likely very volatile returns with more positive years than negative years. However, the negative years could be far more severe and could wipe out the positive years, which is how the market would achieve merely one to four percent over the full 10-year period.

With volatility comes opportunity, but only if you are able to preserve some dry powder for the downturns and remain disciplined enough to jump in when everyone else is bailing out. This means going against the herd by being a little more conservative as the bubble matures and then getting more aggressive when it feels like the world is ending. Risk management and disciplined rebalancing will be the key to preserving and growing wealth over the next decade. It may also be important to incorporate other assets than just traditional U.S. stocks and bonds. As Warren Buffett has said, **"Be fearful when others are greedy and only greedy when others are fearful."**

Investors should revisit their investment strategy (weighing potential upside against potential downside) within the context of their financial goals and tolerance for market volatility. Investors should model at least a 40%-50% decline in the U.S. stock market into their financial projections as a "stress test" and ensure they are comfortable with whatever that may mean for their portfolio and the achievement of their financial goals.

The question is how high will the market rise before the bear market begins? It's an impossible question to answer as we've seen valuations soar much higher than even current levels before topping out. All the valuation measures discussed here are reliable for forecasting 10-year returns but no measure reliably predicts short-term returns so we can't use this data for making short-term investment decisions.

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