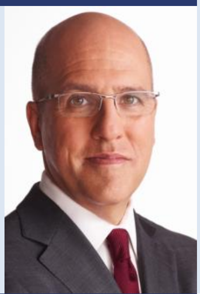

Richard
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80’s Bull Redux

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Four Year Anniversary: It’s not the ’82 bull market, but it sure does look like it

Investors often remember bull markets as days of wine and roses. However, those fond memories are largely based on the latter stages of a bull market during which investors are convinced that there is indeed a bull market underway and that it will never end. They seem to forget that the majority of a bull market is typically characterized by fear and indecision.

Sentiment during the early and middle stages of a bull market is usually clouded by the bad experiences of the prior bear market. Investors are often hesitant to invest in equities for fear of another bear market. Yet, they see higher returns on stocks than the returns they are getting on their more defensive securities. The emotional tug-of-war between fear of another bear market and greed of missing out on higher returns tends to keep most investors sidelined for most of a bull market.

This cycle has certainly been no different. The S&P 500® has produced a total return of more than 140% since the market trough in March 2009, but many investors still do not even believe that a bull market is underway. Investors continue to search for 5% yields and seemingly ignore the much higher total returns that stocks have been producing.

Another 1980s bull market?

We have thought for some time that the current bull market might be one of the strongest of our careers, and could potentially rival the 1980s bull market. Although this current cycle’s construction is quite different from the 1980s bull market, there are many aspects of this market that are curiously similar.

Investors did not fully embrace the 1980s bull market until several years after it began. Institutional investors did not fully appreciate the opportunities in equities until late-1985/early-1986 when oil prices collapsed, and it became clear that inflation was not going to constrain equity returns. Individual investors largely stayed in money market funds and bonds until early-1987 when they were lured into the equity market by January 1987’s 13% one-month return. Individual investors then entered the stock market in droves just in time for the 1987 Crash.

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Similar to what is keeping investors on the sidelines during the current bull market, investors stayed out of the 1980s bull market for so long because there were many issues that investors thought were insurmountable. Table 1 highlights some of the issues that caused investors to forego for many years investing in the 1980s bull market. The irony is that they are largely the same as today's concerns.

Of course, there are subtle differences between the 1980s concerns and today's. In the 1980s, investors were worried that the Fed might tighten too much. Today, investors are concerned the Fed might ease too much. In the 1980s, it was Democrats who were concerned about budget deficits. Today, it is Republicans. The sovereign debt problems during the 1980s were largely associated with Latin America. Today, such concerns generally focus on Europe. In the 1980s, investors were concerned with Social Security bankrupting the nation. Today, it is Medicare and Medicaid.

Focusing on these differences, though, may miss the point. Investors were scared about a broad range of issues during the 1980s bull market, and the list of concerns is nearly identical to today's list of concerns. **Despite what many might suggest, the uncertainties associated with the current cycle are not unique.**

Table 1:

Today's Issue/ Concern	Present during 1980s Bull Market?
• An out-of-control Federal Reserve	√
• Slow growth economy	√
• Iran causing geopolitical risk	√
• Prior decade's sub-par equity returns	√
• Inflation	√
• Federal budget deficits	√
• Federal entitlements	√
• Tax reform	√
• Sovereign debt problems	√
• Declining profit margins	√

Source: Richard Bernstein Advisors

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What are the typical signals that a bear market is coming?

There are three classic signs that have historically strongly suggested that a bear market might be nearing. None of those three signs are evident today in the US. These signs are:

- **The Fed tightens too much** – historically bull markets didn't end when the Fed started to tighten. Rather, they ended after the Fed tightened too much. A classic indicator that the Fed has tightened too much is an inverted yield curve (i.e., short-term rates higher than long-term rates). The Fed has indicated that they do not anticipate tightening anytime soon, and an inverted yield curve seems years away.

- **Significant overvaluation** – Our valuation models continue to suggest that the market is significantly undervalued despite the four-year bull market. More important though is the high level of uncertainty among investors. Uncertainty, according to classic financial theory, indicates undervaluation. Markets tend to be overvalued when investors are certain, and undervalued when investors are uncertain. In fact, this is a financial tautology. Most investors would agree that there is great uncertainty surrounding the US equity market. Therefore, the US market must be undervalued.

- **Euphoria/Asset class of choice** – It is hard to argue that US equities are the asset class of choice when Wall Street strategists are recommending a historically low equity allocation, pension funds have very low equity allocations relative to history, and US equity mutual funds were, until very recently, experiencing net outflows.

These signs are increasingly evident in the emerging markets and, as usual, investors don't believe the signals apply. However, these signals do not appear within the US equity market. It is somewhat ironic that investors are enamored with the emerging markets despite that those markets are showing the typical signs of risk, but feel the US market is too risky even though the risk signals might be years away.

Bull markets are periods of fear and indecision

Bull markets are typically characterized by fear and indecision. This cycle has been no different from that historical norm. We think investors need to realize that this cycle's concerns are not unique, and are similar to the fears during the 1980s bull market. In addition, the typical warning signs, although increasingly evident in the emerging markets, seem a long way away in the US.

Accordingly, our portfolios remain bullishly positioned.

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