CUMBERLAND

END OF A SECULAR BEAR?

It's a New Year and a chance to reflect on the year just passed. So I would like to start with an observation.

The news environment last year was pretty ugly. If you had known at the beginning of 2011 that there would be political turmoil and governments overthrown in the Middle East, starting with Egypt in February, followed by an earthquake and tsunami in Japan that shut down manufacturing worldwide, a series of failed attempts to resolve the sovereign debt problems in Europe leaving Greece teetering on the verge of default, and a failure of the US Congress to deal with their budget deficit that resulted in the U.S. credit rating being downgraded from "AAA", how much would you have guessed the market would have been down? 15%, maybe 20%? Without looking at the results it sure felt like the market was down a lot. But the fact is, in the U.S. markets, the S&P 500 was essentially flat while the Dow Jones finished up about 5%. It's true that the TSX in Canada was down almost 12%, thanks mostly to the resource sector which gave up some of its 2010 performance as it responded to the worldwide economic slowdown.

So much for forecasts. First, you can't predict the news and second, the results are often a paradox to what one might predict.

We all know Europe has problems and if and when they are resolved, this market should move higher. However, you can't wait for the resolution before making an investment. The point here is that unfortunately investing is not a spectator sport. If you want to participate, you have to make a commitment before you know the results, which may be affected by more than what is on the front page of the newspaper. It's because the market generally anticipates the results and would have already discounted them.

The paradox of investing is that it is less an exercise in anticipating good outcomes and more one of understanding the consequences of bad ones. When the news is at its worst the market builds in a risk premium by lowering company valuations. Why don't investors take advantage of that opportunity? Well, good investors do, but most are too paralyzed by the news and want to wait until the outlook improves.

Are we at such a junction? I think so, because a valuation compression has been taking place for over a decade. Investors are fed up. They haven't made money in the markets for years and the future looks risky right now. But, as I said, even if the news this year turns out to be bad, I couldn't guarantee you that the market would react negatively. It might already be "priced in".

So, I want to put this valuation compression into context for you because there is a lot more to the market than economics and what you read in the newspaper.

But before I do, let me give you my two cents worth on what's currently affecting the market.

Certainly, the burning issue that everyone is obsessing over today is Europe. You can't turn on your television or pick up a newspaper without some mention of Greece or potential sovereign debt defaults. People know the name of the Head of the European Central Bank, Mario Draghi, as if he were a rock star.

The situation in Europe is far from being resolved, but I would contend that it has improved and is a far sight better than what it was a year ago.

Our December strategy piece addressed some of the issues, so I'm only going to add a couple of observations.

The first is that I believe the press is taking Angela Merkel too literally, hanging on every word she utters. But does she really mean everything she says, or is it posturing and part of a grand negotiation? I think the latter and believe Germany has the more profligate countries exactly where it wants them. Should Merkel cave in to international demands that the European Central Bank bail out the sovereign bond market she would lose her only negotiating tool to force more austere budgets on some of these countries. In her mind, what is required is better fiscal policy, less spending on social issues and a stronger European community. To get this, she is willing to play brinksmanship to create mini crises that demand government reaction because the market consequences of no actions are far worse than some self-induced austerity pain. So far it has worked. Greece and Italy have new governments and are addressing the deficits by cutting spending.

Is she so belligerent or economically ignorant that she could go too far with this negotiating strategy and lose control of the financial markets?

It is possible, but I don't think so. Regardless, the market considers the European resolution to be binary and is leaning towards the worst possible outcome, failed government bond issues, sovereign government bond defaults, the collapse of the Euro and European banks resulting in deflation and depression.

So why do I favour a "muddle through" outcome as opposed to a sovereign debt collapse? It's because of the change in the policy response from what we saw this summer to what was declared after the December 9th European Lenders Summit.

As I said, I think Merkel is exploiting the market crises to force financial disciplines on profligate countries. It's resulting in a multifaceted solution that is being rolled out versus the hoped for "silver bullet". Because the plan is incremental, you have to step back to see how things have evolved.

The centerpiece of the Greek bailout was a fortified EFSF (European Financial Stability Facility). In theory, the European Central Bank (ECB) isn't allowed to lend directly to sovereigns, only to the banks, but the EFSF can lend directly. Unfortunately, the facility wasn't large enough to fully do the job of preventing a sovereign default. In theory, any resolution had to come with a 2.5 trillion Euro war chest. Why that much? It was estimated that if Portugal, Italy, Ireland, Greece and Spain lost access to the credit markets, this would be the amount that would be required to fund those countries for the next two years.

Consequently, the EFSF was doomed from the start due to its size. France wanted the Fund to have access to the ECB to leverage its resources, but again the Germans blocked that alternative. Why not just have each country expand its commitment to the EFSF? Well this was part of the problem. They couldn't. The EFSF operates under guarantees from the 17 members of the Euro community. It then uses those guarantees to float its own bonds; the member countries don't lend money directly to the fund. Originally each country pledged to repay up to 120% of its guarantee. The credit rating agencies such as Moody's required that the EFSF loans be covered by "AAA" rated countries plus cash for it to maintain its"AAA" rating. To bolster the Fund as part of the Greek bailout, each country agreed to raise its guarantee to 165%, which would allow the EFSF to borrow 452 bn Euros. The trouble with this plan was that the rating agencies look through the EFSF and add this contingent obligation to each guaranteeing a country's debt load. In the case of France, it pushed them up against a rating downgrade from "AAA", which by the way, is still pending sometime in the first quarter. Should this happen, and we expect that it will, the EFSF bonds won't be rated "AAA", thus impairing their ability to borrow. So it is a vicious circle.

To break the loop, two plans were proposed. One to let the Fund become a bank and borrow from the ECB which was pushed by France, and you can see why. The other was to convert the Fund into an insurance company which would form funds to invest in sovereign debt where it would guarantee against the first 30% loss. That still doesn't get you much over 1.0 trillion Euros.

At this point the EFSF is still around, has 452 bn Euros, but obviously isn't the answer.

At this stage, the negotiations shifted from Germany playing brinksmanship with the lending to troubled countries by not providing backstop funding to one of bilateral agreements that would codify and replace the public debt markets as the agent of compliance. Somewhere in the process, Sarkozy stopped asking for an ECB backstop and apparently went along with German demands for bilateral fiscal agreements. At the same time, the ECB said it might be able to better facilitate lending if these fiscal agreements were put into place. Trade off? I think so. These agreements will call for deficit curbs of 0.5% of structural GDP with each country establishing an "automatic corrective mechanism." Also a "near automatic" discipline procedure and more intrusive control over taxing and spending by governments that break the 3% budget deficit to GDP limit.

With these in place, there were two announcements coming out of the December 9th summit. The first from the ECB which established the Long Term Repurchase Operation (LTRO), which would lend banks unlimited amounts for three years.

The second announcement was that the Germans backed off on their demand that the private sector participate in any debt restructuring or write-downs. Does that mean there is an implicit guarantee on sovereign debt? It sure sounds like it.

Following these announcements, the Governor of the European Central Bank, Mario Draghi, said it is up to the banks to decide what to do with the money. "One of the things that they may do is to buy sovereign bonds. But it is just one and it is obviously not at all an equivalent to the ECB stepping up bond buying". Really!

The EFSF certainly didn't have the wherewithal to deal with the sovereign debt problem but the ECB is the lender of last resort and only needs the banks to play along. If you're an Italian bank with lots of Italian sovereign debt that could default if the government doesn't get funded, what would you do?

The first round of ECB funding took place December 21st and not surprisingly, 645 billion Euros were borrowed with a high proportion going to Italian banks. The ECB also changed the definition of what it would take as collateral to include mortgage-backed securities that were rated Single "A" at issuance.

This whole plan looks familiar. Remember the Temporary Liquidity Guarantee Program instituted to lend money to the U.S. banks for three years? Could it be that Ben Bernanke has finally gotten his message through to the Europeans, i.e. print or else?

Bottom line, that is probably the big message here. The Europeans aren't going to let their governments default. This could result in massive quantitative easing and you better own "real assets", not bonds.

U.S. Economy

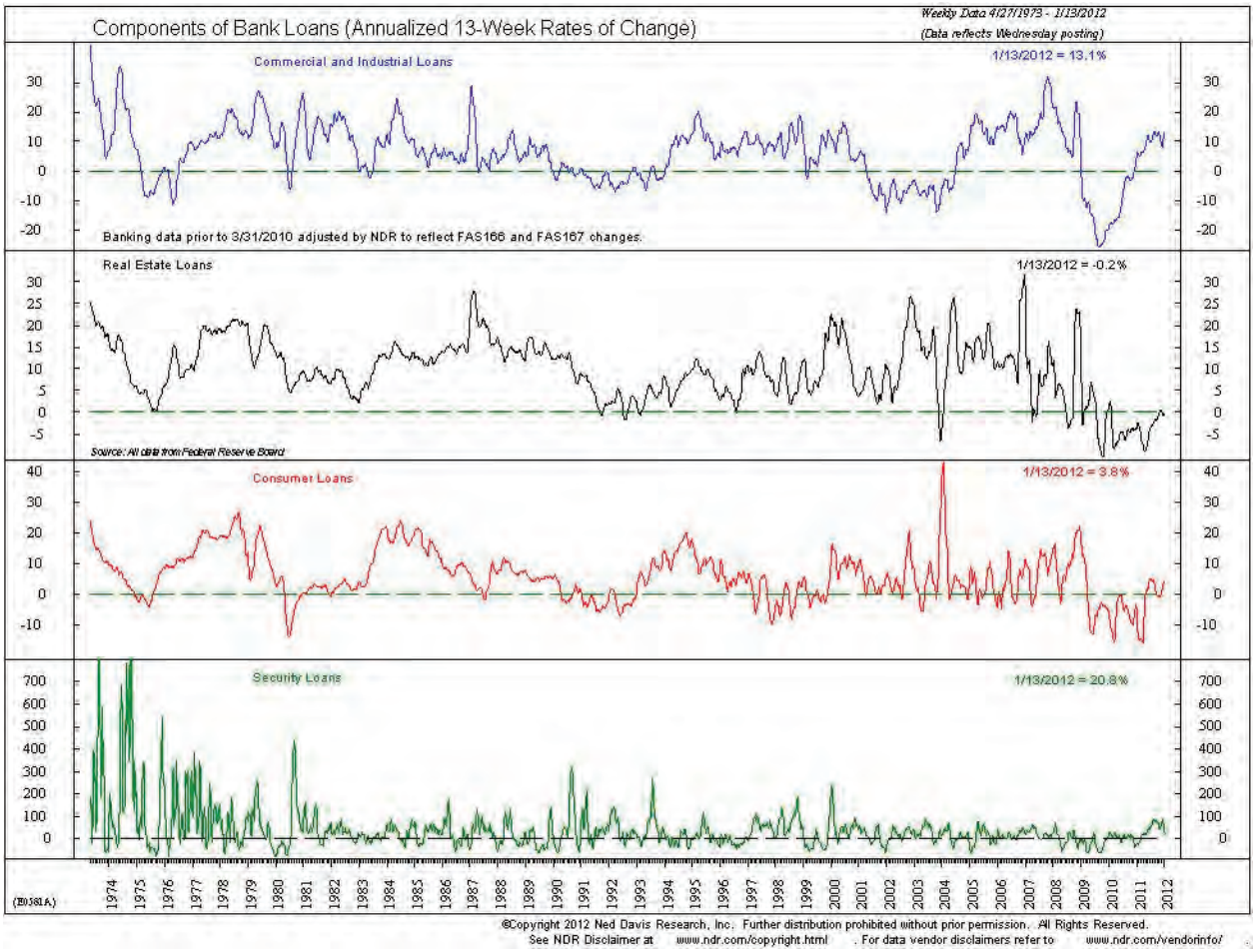
As bad as things seem in Europe they're better in the United States. After listening to forecasts that the U.S. was falling back into recession for most of this summer, the statistics never suggested anything more than a slowdown. Lately, the economic reports are quite positive:

- Payrolls are expanding. 200,000 jobs were added in December and caps four months of declining unemployment. Last year 1.64 million jobs were created, the best year since 2006.
- Corporate capital spending continues to increase.
- Housing starts in November jumped 9.3% to 685,000, the highest in 19 months.
- Household debt payments as a percentage of disposable income fell to 11% in the 3rd quarter. That's the lowest since 1994.
- December auto sales reached 13.5 million units on a seasonally adjusted basis, up 25% sequentially.
- U.S. export orders rose in December to a three month high in spite of the slowdown in Europe.

Unfortunately, the sheer number of economic releases and their adjustments can be overwhelming. And, not each report will suggest an expanding economy. There will no doubt be some setbacks.

But, right now I would focus on two series, bank lending and housing starts.

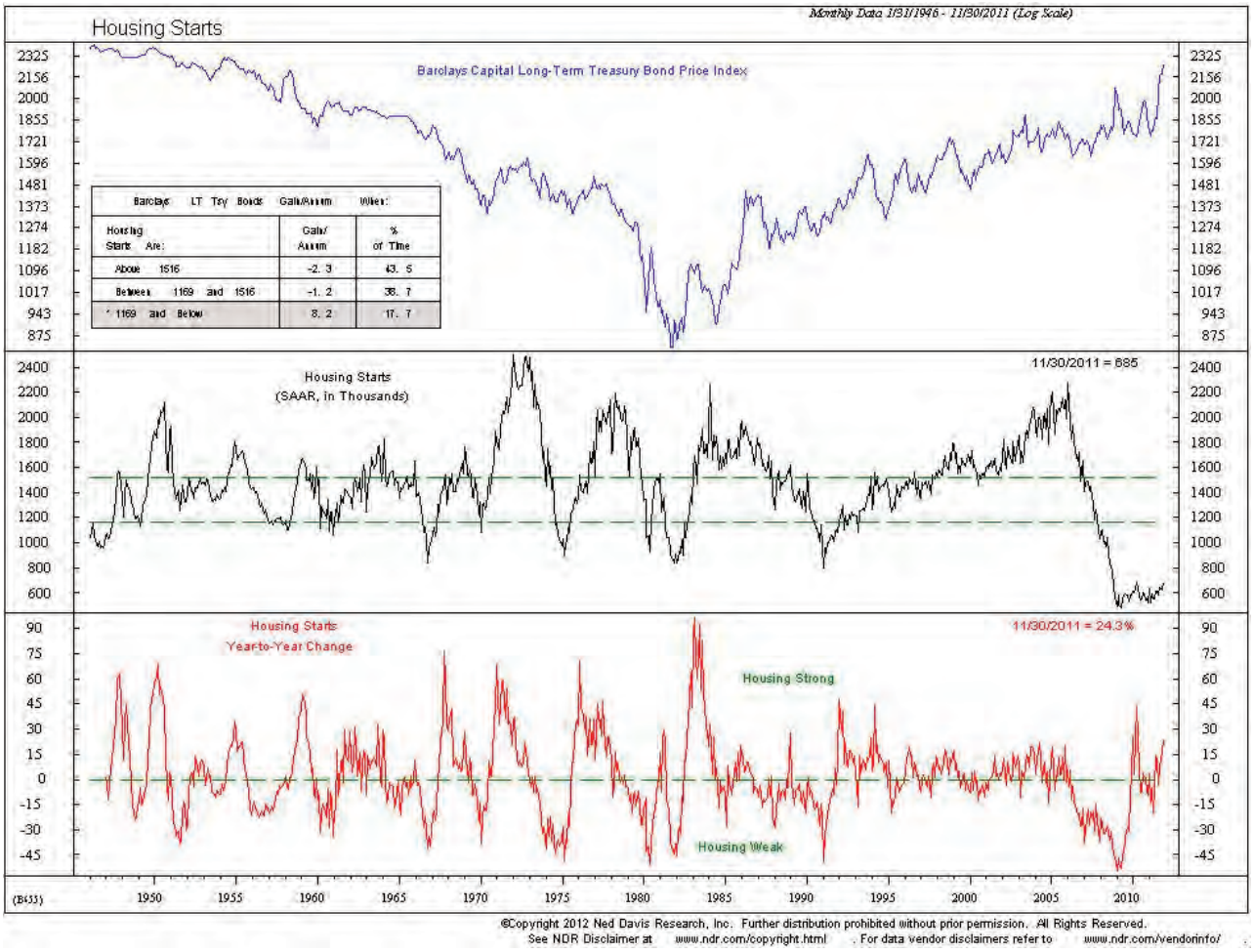
Bank lending will tell you what people are actually doing. It's a vote on the future direction of the economy and it's unadjusted. So you get the straight goods on what's happening without some bureaucrat making an interpretation of the data.



Right now, lending is picking up as you can see in this chart. Total loans went positive this summer on the back of commercial and industrial loans which have been strong since the end of 2010. However, consumer loans have also turned up in the last couple of quarters as revolving credit (credit cards) has stopped declining. The only remaining sector yet to turn is real estate lending but it has also stopped declining and is at breakeven.

Any further improvement is a "real time" barometer on the economy, especially considering that consumer spending is 70% of GDP.

The second series that I would watch is housing starts. They don't necessarily have to pick up, but if they do it will be a good leading indicator for employment. It's where the U.S. lost a lot of jobs and it has yet to recover, but there are some hopeful signs.



Everyone knows that there is still an overhang of unsold homes either owned by the banks or those delinquent on their mortgages. Yet, housing construction bottomed out in 2009 and has finally started to pick up. In November, starts improved 24.3% year over year as seen in the bottom clip of this chart, while building permits hit a three year high in October.

There is a virtual cycle that could kick in here to make the economic recovery self-sustaining.

Housing starts are related to family formations, which usually run around 1.25 million per year. But because jobs have been scarce, family formations have been cut about in half as the unemployed stay at home.

A few more jobs would lead to better household formations, which leads to improved housing starts, and more jobs. This could be a factor in 2012 and would be a big positive for the economy and the market.

Summary

Let me stop there before I try to put this market into a longer term perspective and tell you that I'm positive on the market and have been a buyer through the fall.

Last quarter, I focused on price earnings ratios for the market being as cheap as we've seen since the 1990's. That hasn't changed much. I've also pointed out in the past, the huge amount of money held by individuals that's sitting on the sidelines as latent buying power earning almost nothing. That also hasn't changed.

In this piece, I want to focus on corporate cash. Right now it's estimated that there is $3.8 trillion of cash sitting on their balance sheets. They have three options for this money. Keep it, so that they don't get caught in a liquidity bind like they did in 2008, a pretty expensive option. Second, they can pay it out to their shareholders through either dividends or share buybacks. Third, they can use the money for acquisitions or capital expenditures. Either of the last two options would be good for the market but let's concentrate on option number two.

J.P. Morgan did an interesting study, so let me paraphrase some of their findings.

•S&P 500 profits were at all time highs in 2011, but despite this, corporate cash returned to shareholders in either dividends or share buybacks, is nowhere close to past highs. They compiled records on 15,000 publicly traded stocks and concluded that cash returned to shareholders as a percentage of profits is currently about 41%, around the lowest levels since 1990 and well below the 20 year average of 51%.

They also noted that in the later years of an expansion, the figure usually rises to 65% - 80%. In 2007 companies distributed 78% of profits. In 2000, distributions hit 84% of profits.

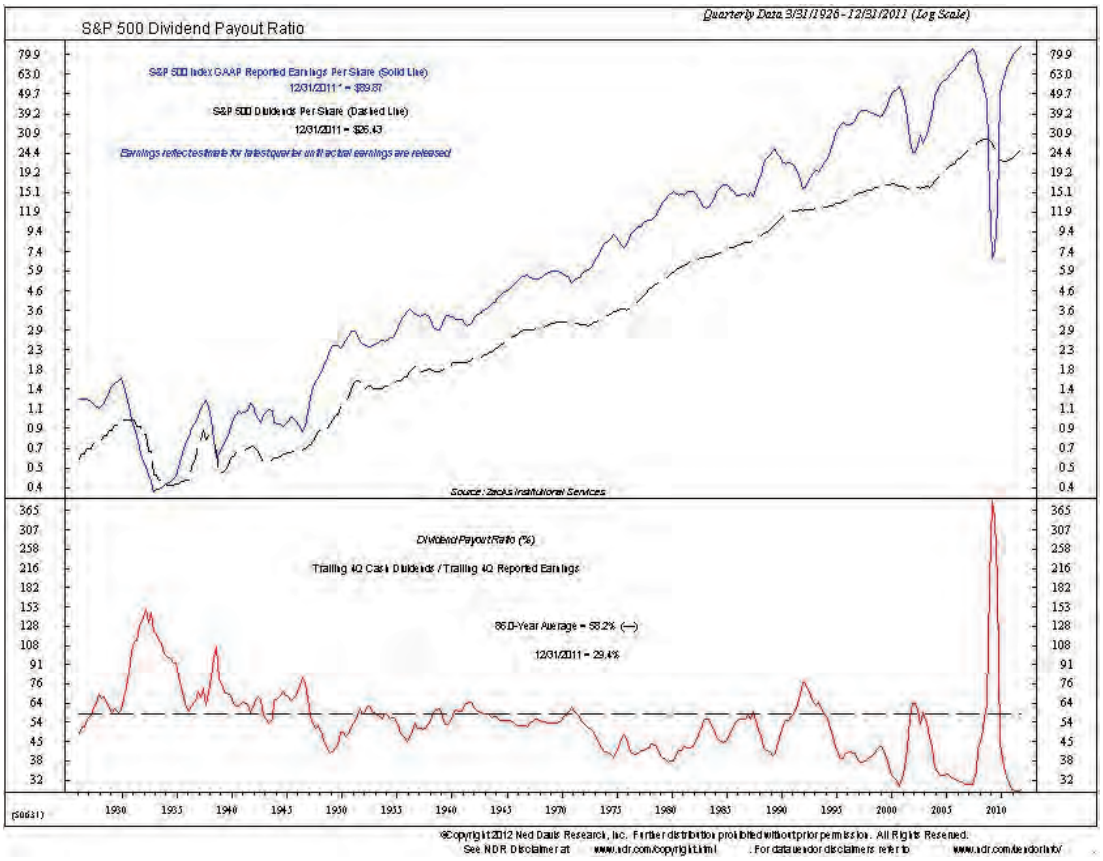
If you normalize corporate cash returned, it would imply a buyback level of $1.1 to $1.2 trillion versus $880 billion today.

The difference of $300 to $400 billion could be compared to mutual fund sales and would be equal to the largest single year of inflows into equities.

•Since 1990, buybacks and dividends have been the largest incremental source of market demand. In total, there has been $11.5 trillion of total incremental inflows to equities since 1990. Of this, mutual funds accounted for $1.9 trillion while $9.6 trillion came from corporations.

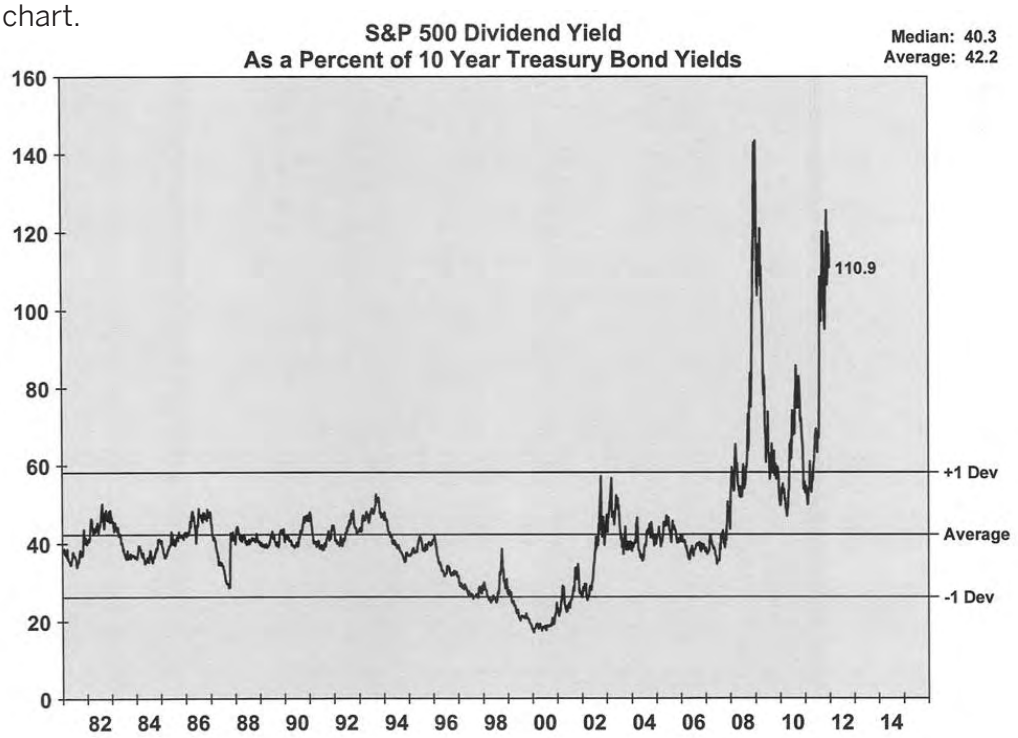
•33% of S&P companies have bought back at least 10% of their shares in the past 5 years.

Whether corporations buy back stock or increase dividends, it will help the market. Between 2005 and 2009, corporate buybacks represented 60% of their total distribution. But that could change.

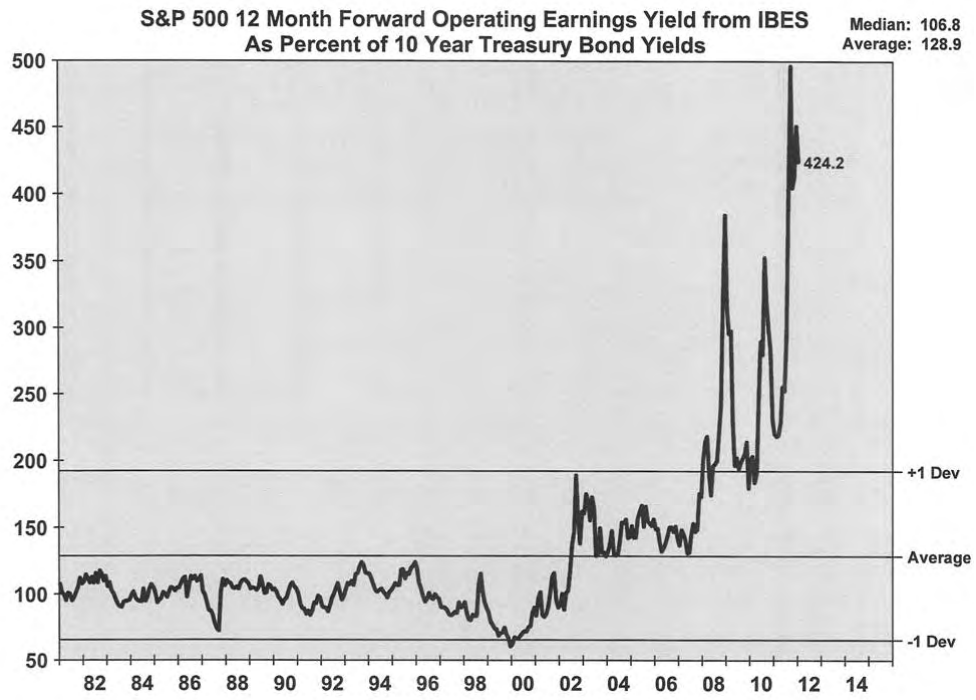


Take a look at this chart. It indicates that the dividend payout ratio is close to a record low at 29.4%, suggesting that companies have the capacity to raise dividends.

Now look at corporate valuations based on dividend yield compared to 10 year Treasury Bond yields in the following chart.



It indicates that the S&P 500 dividend yield compared to Treasuries is almost 3 times higher than normal.



Similarly, the corporate earnings yield compared to Treasuries is almost 3½ times higher than normal.

By either metric, the market is compellingly cheap, especially for yield starved savers, many of whom are baby boomers verging on retirement.

Given what is happening in Europe, my preference is for high quality, dividend-paying stocks that have better dividend returns than bonds.

Is there any appreciation potential? I think so, both from an earnings growth perspective and also from a secular valuation perspective. Read on.

End of a Secular Bear Market

It used to be a lot of fun to be an investment manager. Everyone wanted to know what you were buying. Now, no one wants to talk to you. "The stock market, forget it, I haven't made money in the market in ten years. It's either rigged by the hedge funds or just a lousy, risky place to put your money. I'd rather buy gold, real estate or bonds."

It got me to thinking that I haven't been this unloved since the '70's. No one wanted to talk to me back then either. In 1979, Business Week even titled the cover of their magazine "The Death of Equities." I was reminded of this when I read a Gallop poll conducted last August where 34% of the respondents said that gold was the best long term investment, while real estate came in second and equities finished in last place.

This was recently reinforced when I attended an investor's conference where each of the twelve attendees articulated their current investment strategy. A number held sizeable positions in gold bullion. Others were in private equity, a lot in real estate and bonds. Only three of us owned equities. One was thinking of getting out because he hadn't seen any returns in four years. Too bad he wasn't a Cumberland client. Another had a small equity exposure and was actually thinking about buying more, but found the economic environment too unsettling.

When it came to me, I said I was buying equities and probably had more exposure today than any time in my life.

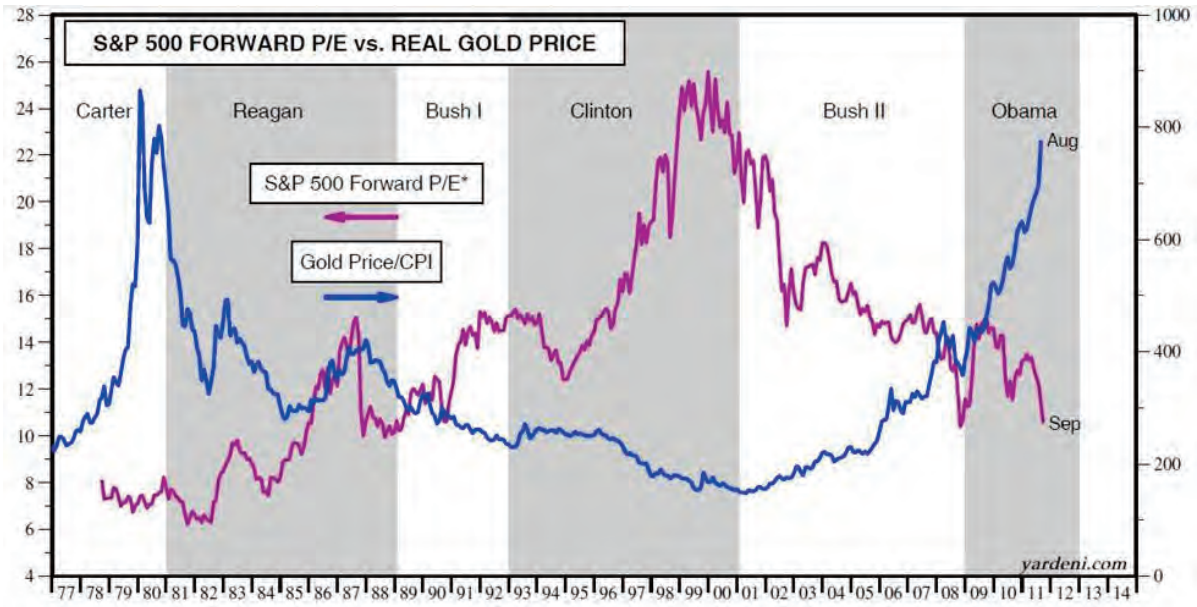
Given my occupation, the groans were almost audible; I could see that no one was going to want to sit next to me at dinner.

So, I tried to put my strategy into perspective by suggesting that they "rewind this movie" by 12 years. It's now 1999 and I could guarantee them that everyone at the table would have been talking about the stock market and their favourite high tech stock. No one would be in gold; it was $253.00 an ounce. And real estate, forget it, no one had made any money in it for ten years.

However, if you were with Cumberland in the late nineties you know we were selling equities, out of high tech and buying old garment factories and warehouses on the near west side of Toronto's business district at King and Spadina. If memory serves me correctly, our cost was around $47.00 per square foot. Now, they were run down and required a lot of renovating but it was a buyer's market.

Today buyers are lined up at $300.00 per square foot; they love gold as it hit $1900 per ounce while equities are at a valuation we haven't seen since 1990.

Something similar was also happening in the 1970's. We were finishing a 14 year secular bear market that left equities washed out and one of the best buying opportunities of the century. Today, 11 years into a secular bear and again equities are getting washed out as investors are fed up.



* Price divided by 52-week forward consensus expected operating earnings per share.
Source: Thomson Financial.

Last quarter, I used this chart that plots the S&P 500 price earnings ratios from 1978 through September of 2011. As you can see, valuations are back to levels last seen in 1990 with the exception of the recent market bottom at the end of 2008.

Gold, on the other hand, is close to its 1981 peak on an inflation adjusted basis.

As an investor, you only have four options on what to do with your money. You can buy bonds or money market instruments if you're worried about another market crash and a 2008 experience. But don't look for reasonable returns. Thirty-year U.S. government bonds yields 3.0%. Compare that to 15% in 1981 after a long bear market in bonds that started in 1946 with yields at 2.1%. So the current bull market in bonds is now 30 years old while the preceding bear market lasted 35 years. Long cycles.

Gold is another option, but again it has risen from $253.25 per ounce in 1999 to a recent peak of over $1900/oz for a 750% advance over 12 years.

Real estate is a third option. But if measured by "cap rates", the values have doubled from the mid '90's prices over 15 years.

Equities are the fourth option and conversely to the other three options, have been out of favour for 12 years.

The point here is that investment cycles last a long time and don't tend to bottom until they have washed everyone out, or peak until they have seduced the last holdout.

Obviously, I'm bullish on the fourth option and less enthusiastic about the other three. As for bonds specifically, I don't think there is any doubt that interest rates have been manipulated to artificially low levels by the Central Banks.

So, I thought it might be interesting, if not informative, to go back and compare the 1970's to the last decade since 1999.

But first, let me start with a definition of a bear market because understanding a secular revaluation can be a lot more sinister than a garden variety decline of 20% or more. Why sinister? It's because of the subtlety of robbing investors during their foremost savings years. Just imagine if you were 55 years old in 1968 and put your retirement savings in the stock market. Fourteen years later at 69, you're retiring and you've made no return on your savings. In fact, after inflation, and there was a lot of it back then, you are in trouble.

So, most think of a bear market as an absolute decline in the value of their investments. Think 2001 or 2008. But there are two other types of bear markets. One is a compression in valuation. Stock prices don't change that much, even though companies perform well and their earnings continue to improve. That essentially is what we have seen from 2000 through to today and what we saw from 1972 through 1982.

Inflation is the third evil, as even flat markets render savings and investments worth less in real terms, which can impair retirement living standards. The '70's was a lethal combination of these last two forms of bear markets.

The bear market we've endured since 1999 has had its ups and downs, but is a classic valuation compression with corporations generally doing well but price earnings ratios collapsing from over 20 times to roughly 8 times in 2009. With valuations being cut by over 60% is there any wonder why investors are disenchanted with the market? Let me give you an example that makes my point. Suppose you bought Microsoft, a great company, in 2000 at $120.00. It was earning $1.85 per share and traded at 65X earnings. Today, after adjusting for splits, the stock is at $52.00, earns $5.50 and trades at 9.5X earnings. Over this period, Microsoft, has performed very well, earnings have tripled, yet as an investor you lost 52%, excluding dividends.

More importantly, does it suggest gold, which is up 750% or real estate with "cap rates" at two decade lows, are better investments?

I think not. One of the things I've observed over 40 years in this business is that most investors take recent past experiences and project them linearly into the future. In other words, they invest by looking in the rear view mirror instead of out the front windshield.

My father always worried about the depression. Today most investors are approaching equities with visions of 2008 in their mind. The reality is that the future isn't linear. Things regress to their long term mean and the operative word here is "long term." These cycles can last a long time, but recognizing them can lead to the greatest opportunities or the avoidance of unappreciated risks.

The current valuation compression cycle is twelve years old, no youngster as measured by past cycles.

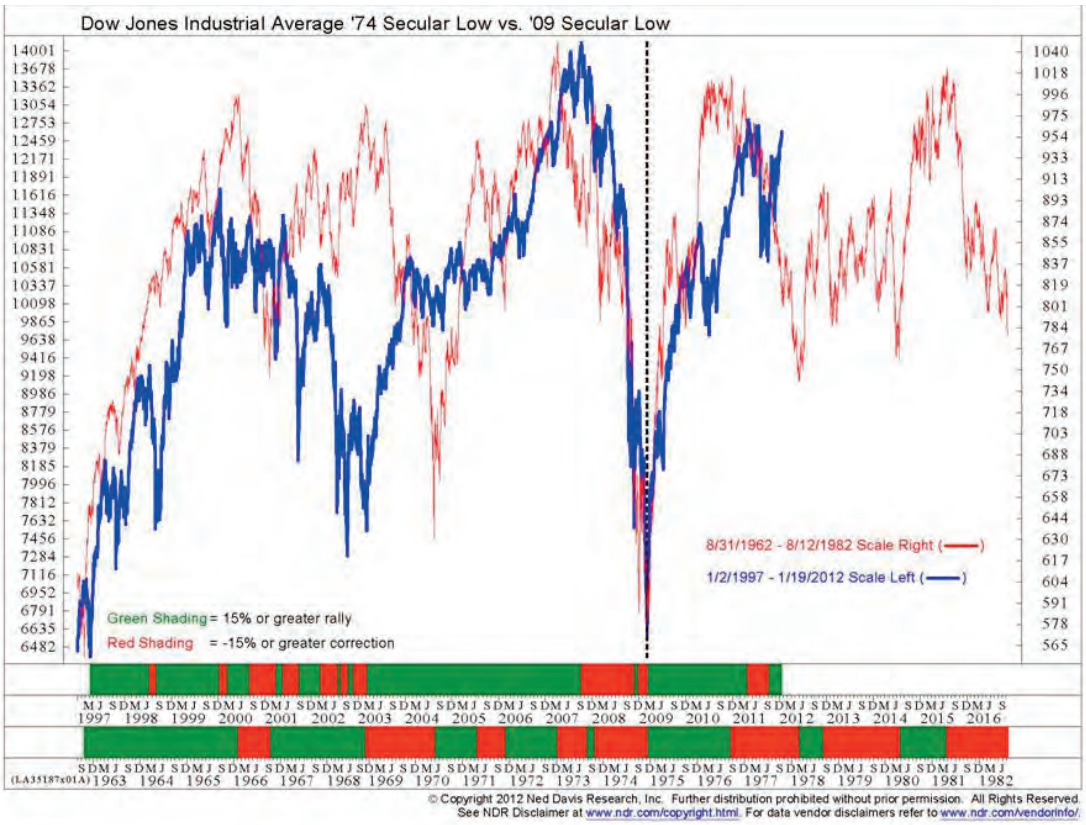
Will it end tomorrow or did it end in 2008? That I don't know. The recognition of value is actually a lousy timing tool and it is still possible that this cycle has one more down leg that takes us to lower absolute valuations and finishes off the last remaining equity investor holdouts. Regardless, at some point these valuations will regress higher and back towards their long term mean.

Being a good investor first requires the recognition of where we are at in the cycle and then the conviction to take advantage of the opportunities that it will present even in the face of consensus opinion to the contrary.

There have been a lot of secular cycles in the market and I'll give you a sampling, but I want to focus on one specifically, the 1970's.

As for other long cycles, the 1949 bull market started with price earnings ratios at 5.9X and it didn't end until 1961 with valuations at 24.2X. The market then was subject to a series of declining valuations. Down to 16.2 X in 1962; then 13.5X in 1966; 12.8X in 1970 and finally 6.97X in 1974 and 6.68X in 1980 with intermittent cyclical bull rallies. So all through the sixties, valuations declined but earnings rose faster which more than offset this, causing the market averages to actually improve, but not by much.

To compare the 2000's against the 1970's we overlaid the Dow Jones Index Averages in those periods to coincide at the market bottom in 1974 and 2009.



As you can see, there is a reasonable fit except for the 1968 peak against the 2002 market bottom where the timing was off by about two years. The market bottom in 1970 would have been a better fit for 2002. The absolute declines are also easy to see. But a stealth bear market also took place between the 1999 peak when the S&P 500 was earning $49.81, and traded at 1,469.3 which was 29.5X earnings, and the 2007 top when the S&P earnings had climbed to $85.32 but the averages were virtually unchanged at 1,468.4 and trading at only 17.2X earnings. In 1972 the market peaked at 19X and although earnings again continued to improve, valuations dropped to 6.7X by 1980.

The market dynamics however, don't line up quite as well as the chronology record.

In the earlier period, the Dow Jones peaked in 1968, then declined for 2 years to the 1970 bottom. It then rallied to the 1972 peak before collapsing in 1974. 1968 was the peak of the broad market while 1972 saw a handful of stocks nicknamed "The Nifty Fifty" carry the market to a slightly higher level than 1968.

The 2000's experience was similar. The broad market peaked in 1998 but the "New Economy Stocks," mostly technology companies, carried the averages to new highs in 1999 before they flamed out, setting a market bottom in 2002. The peaks in 1972 and 1999 had very similar causes and are essentially quite comparable. And, they both did a lot of damage to investor confidence.

In the 70's, the market literally crashed 45% in two years and then traded sideways for another eight years which washed everyone out.

However, in the 2000's the market rallied after 2002 as energy and mining, especially gold, carried the market back to the earlier highs in 2007 before experiencing a similar decline to 1974.

When you compare those two market bottoms after the '72 and '99 peaks, the damage done to individual stocks was quite similar.

1972 - 1974

Average Price Earnings ratio (PE) of the "Nifty Fifty" was 42X while the S&P 500 traded at 19.2X. The average "Nifty Fifty" stock declined 62%.

At the bottom in 1974, the market in nominal terms, was back to the 1958 level. In real terms, after inflation, the market declined another 13% by 1982 putting it back to levels last seen in 1905.

Sample of Names

Company	1972 P.E.	Decline by 1974
Xerox	49X	73%
Aum Products	65X	86%
Polaroid	91X	91%
MacDonalds	86X	72%
Disney	82X	85%
Baxter Travenol	79X	61%
Kresge (Kmart)	54X	63%
Eastman Kodak	48X	61%
Anheuse Bush	68X	69%
Coca-Cola	48X	72%
American Express	39X	72%

The Nifty Fifty were considered "one decision stocks", meaning that once you bought them you would never have to sell them because they were American's premier growth companies. Supposedly, even if you paid too much, it didn't matter because the company's earnings would grow into the valuation.

The reality is that pension plan sponsors were chasing performance and Morgan Guaranty became the "go to" money manager. As they continued to collect assets it became apparent that they were too big to be able to trade the market or do any sector rotation. So they focused on buying essentially 50 companies and as they acquired the management of additional portfolios, they sold the stocks not on their list, thus putting pressure on the broad market. Unfortunately, when things went into reverse in 1973 and as Morgan lost mandates, those same 50 stocks got liquidated resulting in the damage just identified.

1999 – 2002

The stocks driving the market at the end of the 90's were known as "New Economy" companies. This "tech bubble" officially started in August of 1995. That was when Netscape made its initial public offering. The shares opened on the exchange at $28.00 and shot to $75.00 before closing that day at $58.25.

Again, there was a belief that technology represents the way of the future and earnings would grow forever. More traditional money managers were losing accounts to 23 year old techies who sold the old economy stocks down to unreasonably low valuations while driving the New Economy stocks to 1974 type valuations.

By 2002, a sample list of technology stocks had declined by 78.3%.

Sample of Names

Company	P.E.	Decline	Decline in Price
Yahoo	947X	97%	$250 - $8.00
Cisco	193X	87%	$82 - $11.00
Intel	62X	75%	$75.8 - $19.00
Microsoft	65X	66%	$119.9 - $40.30
Ariba	infinite	99%	$183.3 - $ 1.40
Ciena	192X	94%	$151 - $9.40
IBM	34X	41%	$134 - $80.10
Amazon.com	infinite	95%	$113 - $5.5
Ebay	2708X	79%	$127 - $26.90

Other Notable Declines

Motorala	83%
Applied Materials	77%
American Online	71%
Compaq Computer	79%
Dell Computer	73%
Global Crossing	97%
JDS Uniphase	97%
Nortel	95%

The early 2000's and 1970's markets were comparable in that it was a narrow group of stocks pushed by a small group of investment managers that drove the market to unrealistic highs before collapsing. At their peaks they had seduced investors into ignoring their valuation disciplines and to chase a concept.

The 2009 market bottom was similar to 1974 in that it was the resource stocks that collapsed after they had put in the highs during 2007 with predictions of $200 oil. Again, an unchallenged belief that we were running out of resources drove the commodity stocks to unprecedented levels before the recession and the liquidity crisis of 2008 exposed the failing of that proposition and again investors got hurt.

Unlike tops, secular bottoms are set after long periods of disappointment, eventually discouraging investors. Their belief of what lies ahead, is as full of despair, as the top was of hope.

After 1974 it took 8 years for the market to set a new high while the 2009 bottom is only 3 years behind us, so maybe there is further to go in the current cycle.

However, the peaks of 1972 and 1999 are very similar, and it was 10 years after the 1972 peak that the market finally reached new highs. We're now finishing the 12th year after the "tech" peak and valuations are close to two decade lows, similar to what we saw in 1981 just before the market took off.

It was also 10 years of valuation compression from top to bottom. It is true valuations today aren't as washed out as they were in the '70's, but there were two fundamental differences which could account for this, inflation and interest rates.

Then, inflation was raging on the back of an Iranian Oil embargo. Earnings were inflated by inventory gains which investors were unwilling to pay for. It's estimated that these inventory gains amounted to 15% of earnings compared to roughly only 3% today.

Second, interest rates were on their way to 15% on 30 year U.S. government bonds. That was pretty stiff competition for the equity markets and soaked up a lot of money.

Perversely, we're seeing the same thinking today not because interest rates are high, but because the risk premium is high. People are frightened and worried about the future, so they're not willing to pay much in the form of valuation for future earnings. As James Grant put it in his Interest Rate Observer, "P.E.'s have been falling in tandem with interest rates. It could be that this multiple compression presages lower profit margins, slower growth or a more punitive regulatory environment. Or it could be that sagging P.E.'s are simply the mirrors to a demoralized world."

From my perspective, it's more important to know what is priced into the market before making an investment than to bet on some anticipated future outcome. As I said in the beginning, no one can predict what will happen and even if you could, the odds of knowing how it will affect the market are limited.

By recognizing that potentially bad news is already priced in, gives you a margin of safety. I think we're close to an inflection point where the ebb and flow of investor confidence is about to change back in favour of equities.

GRC/amh
January 12, 2012

Credits:
Ned Davis
Yardeni
J.P. Morgan
Anatomy of the Bear – Russel Napier
Grant's Interest Rate Observer
TD Asset Management