*Walter Deemer's*

# MARKET STRATEGIES AND INSIGHTS

***...for Sophisticated Institutional Investors***

December 31, 2010

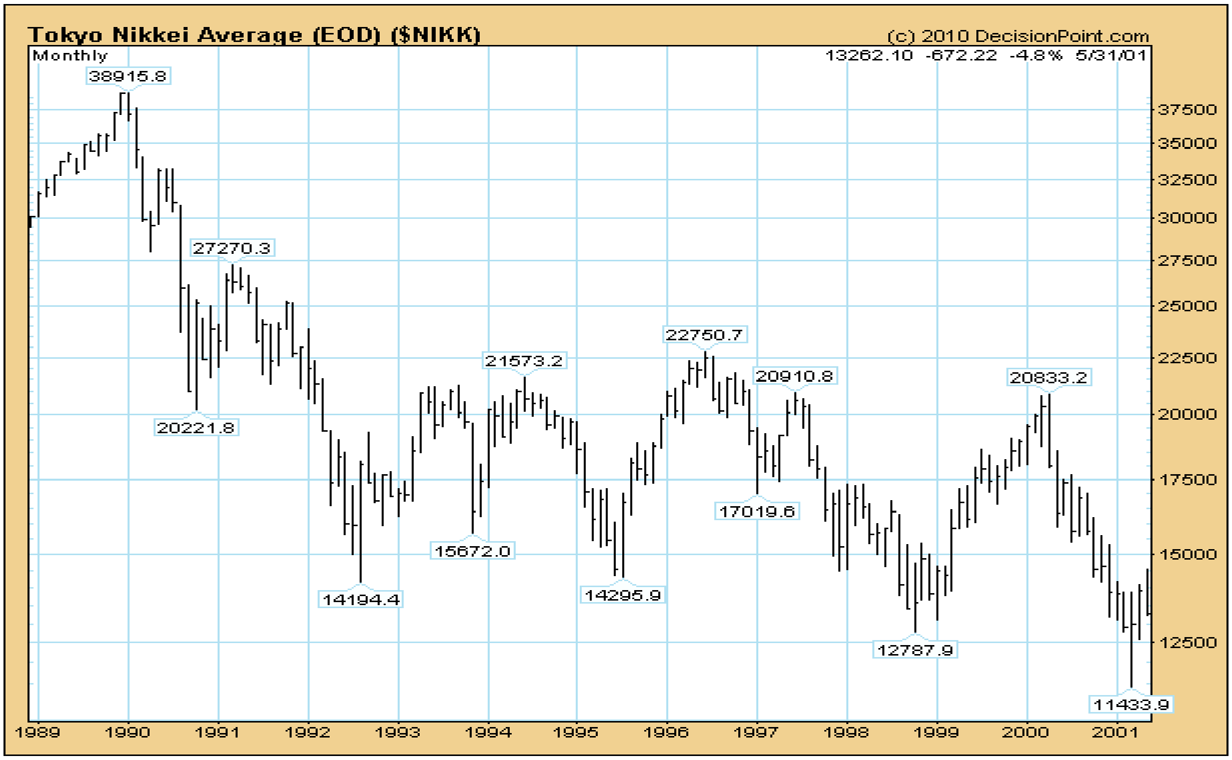
## PUTTING THINGS INTO LONG-TERM PERSPECTIVE

Those of us who came into the investment business in the 1960's, 1970's, 1980's and 1990's spent our entire professional lives in a credit-expansionary environment with its accompanying inflationary pressures. The investment lessons we learned and the parameters we learned to apply during that time were all products of that environment.

That all changed in 2007-2008, though, when we were suddenly and rudely thrust into a credit-contraction environment with its accompanying deflationary pressures. All of a sudden, the investment lessons we had all learned so well during our careers no longer necessarily applied and the parameters we had become accustomed to were no longer necessarily valid. For me, this was driven forcefully home in August-October 2008 by two things. First, the Leuthold Group's Major Trend Index, an amalgamation of many, many different factors which had a most enviable long-term track record track turned positive that August, when the S&P was still all the way up at 1250; those "many, many different factors", as it turned out, didn't work in our new environment. And second, Lowry's long-term oversold indicator, the best such indicator I know of, reached unbelievably oversold levels in September and October of 2008 – but with no response whatsoever from the market. When tried-and-true battle-tested long-term indicators stop working as dramatically as that, something very basic has changed.

I make my living by, among other things, finding past analogies for what the financial markets are doing at a given time. This time, though, I was stumped. We hadn't seen conditions like these in the United States since the 1930's, but the economic and monetary environments are so vastly different now than they were then comparisons were, at best, a tremendous stretch. Japan, though, entered a deflationary period in 1990, and although our current situation is much different than theirs (Japan, among other things, did not have the world's reserve currency, as we do) it is the best/only one I can come up with as far as the financial markets are concerned. A quick review of the Japanese stock market in the 1990's is thus in order.


Tokyo Nikkei Average (EOD) ($NIKK)
(c) 2010 DecisionPoint.com
Monthly
13262.10 -672.22 -4.8% 5/31/01
38915.8
27270.3
20221.8
14194.4
15672.0
21573.2
14295.9
22750.7
20910.8
17019.6
12787.9
20833.2
11433.9
37500
35000
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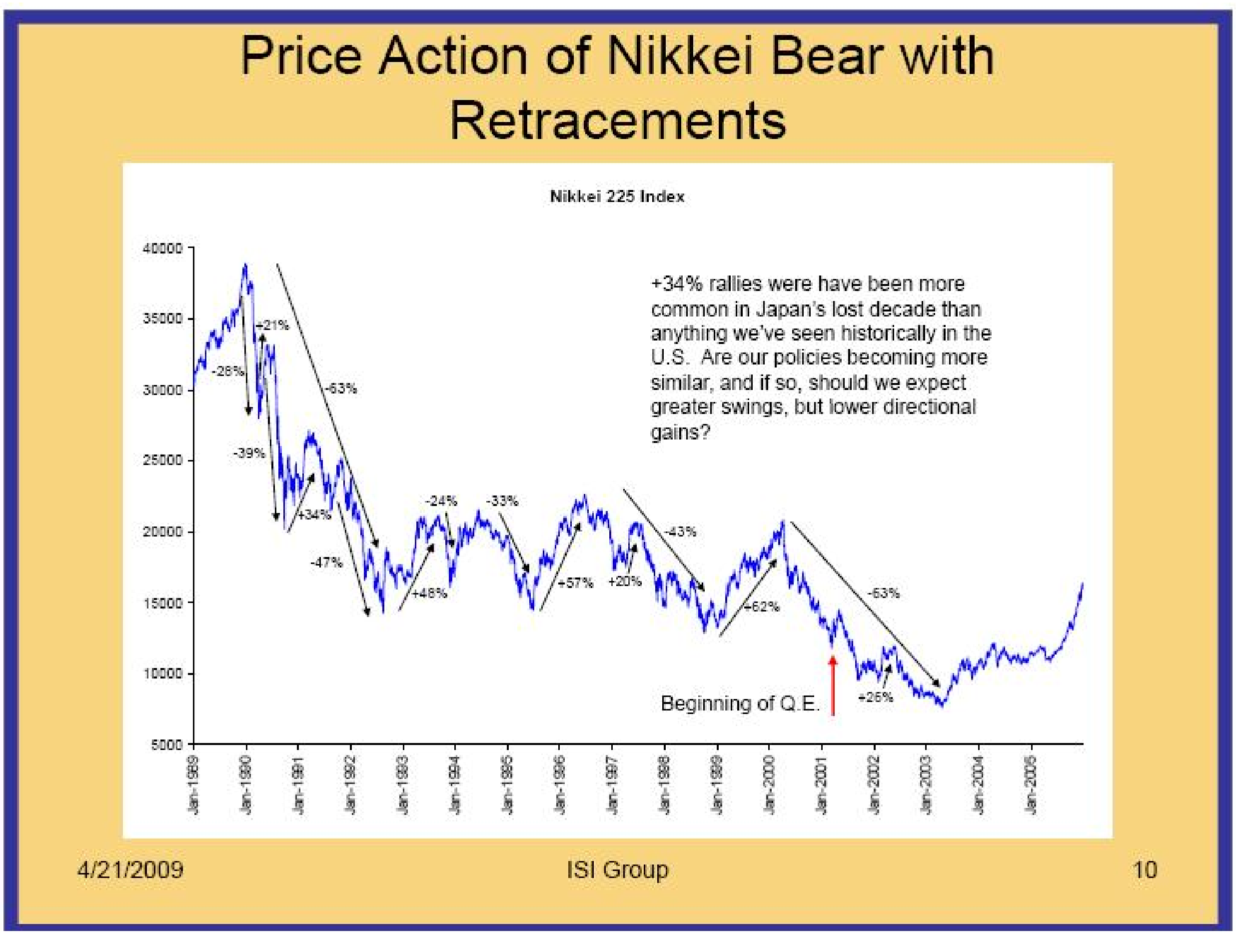

Price Action of Nikkei Bear with Retracements
Nikkei 225 Index
+34% rallies were have been more common in Japan's lost decade than anything we've seen historically in the U.S. Are our policies becoming more similar, and if so, should we expect greater swings, but lower directional gains?
Beginning of Q.E.
4/21/2009
ISI Group
10

The Japanese Stock Market In The 1990's.

The Japanese stock market, following the initial collapse from the 1989 high, staged three great advances during the 1990's: 52% in 1992-1994, 60% in 1995-1996 and 63% in 1998-2000. The important takeaway for investors, though, is that the latter two advances were completely retraced by the subsequent decline and the one in 1992-1994 virtually did so as well via a 99% retracement. (The 1992-1994 advance actually had two corrective legs; the first one "only" retraced 79% of the preceding advance while the second one retraced all of the preceding advance and 99% of the entire advance.)

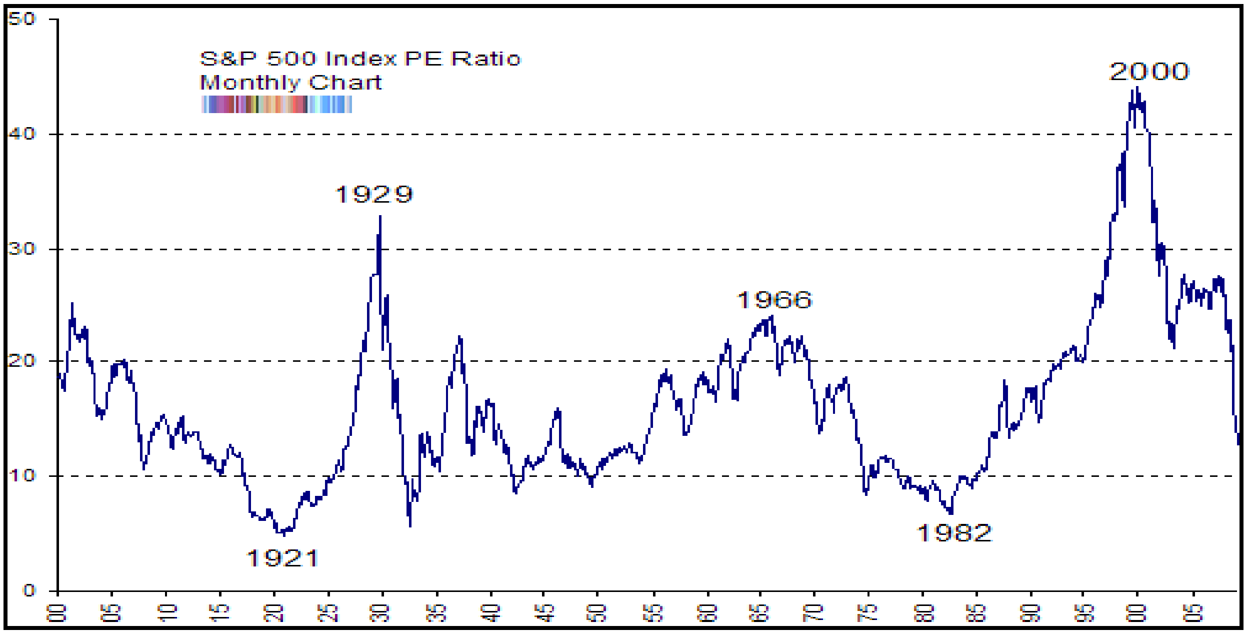
The first credit deleveraging decade in Japan, in other words, was accompanied by a very-wide swinging market with an overall sideways-to-down bias – not the upward one that had preceded it. And, for what it's worth, the U. S. stock market didn't have an upward bias either after its initial recovery in the 1930's. From this, I therefore expect the U. S. stock market to move more or less generally sideways with big swings in both directions for a long, long time.

Regressing To The Mean

There's a lot of talk these days about long-term data series having "regressed to the mean". But does regressing to the mean indicate that getting to the mean is all there is?

The answer is "no".

The best illustration of a data series that's regressed to the mean is probably P/E ratios. P/E's in the broad market swung from a secular peak in the late 1920's to a secular trough in 1946-49 when the Dow traded at just 6 times earnings, another secular peak in 1966, another trough in 1982, and their most recent secular peak in 2000 (when tech stocks distorted the data dramatically) and 2007. P/E ratios thus spend their time bouncing back and forth between very high and very low levels, and when I worked at Putnam in the 1970's we had a chart from T. Rowe Price that said the mean was 15 – which is just about where they are now. The long-term bulls thus argue – and rather strenuously so -- that since P/E ratios have now regressed back to the mean that's a good place for them to stop.

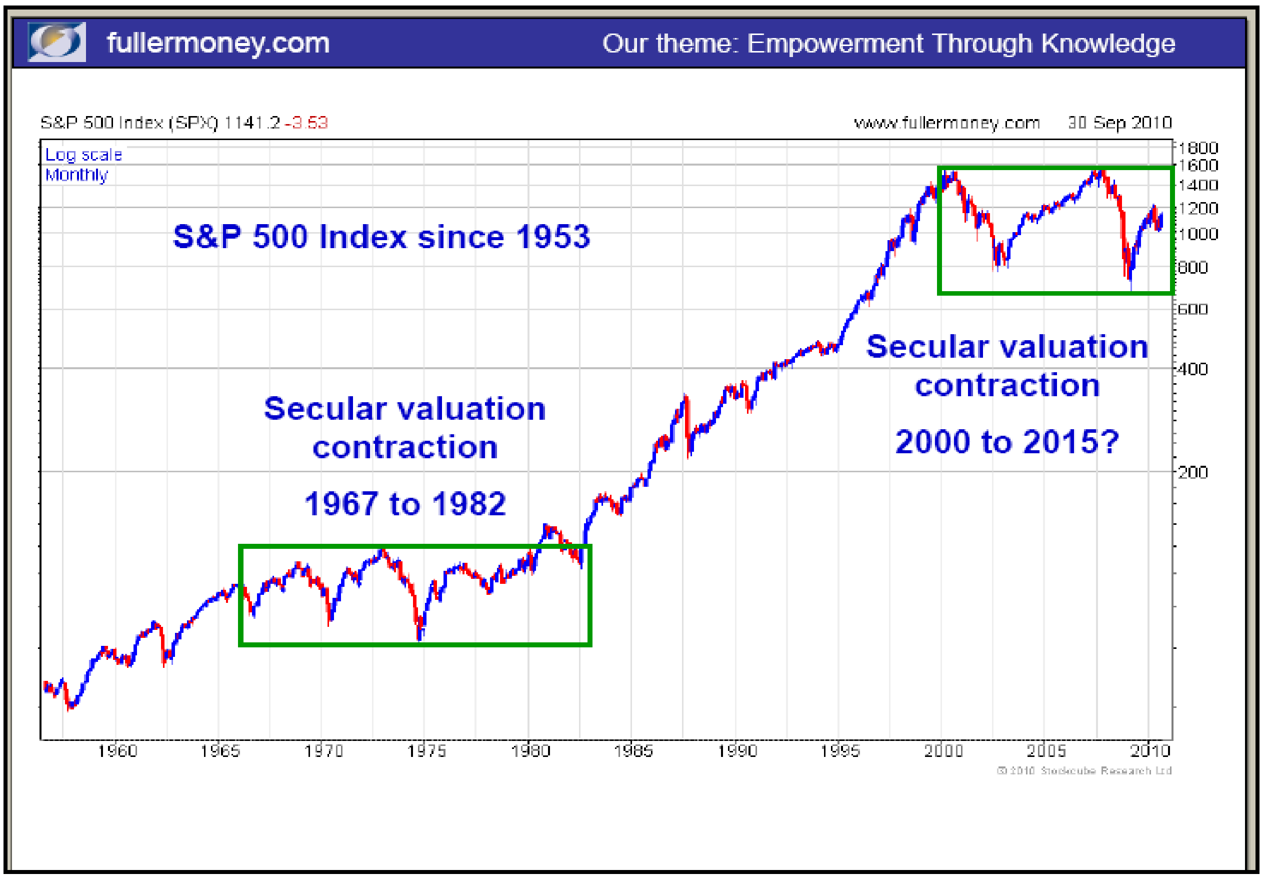



Sorry; it isn't. The reason that the mean is 15 is because there are a series of unusually-high readings and an equal number of unusually-low readings. To vastly oversimplify: if the series of unusually-high readings averaged 25 and the equal number of unusually-low readings averaged 5, the mean would be 15 – which it is. If the contractions from the high (25) stopped at the "mean" (15), though, the mean wouldn't be 15 – it would be 20. (And if the correction stopped at 20 the mean would be 22½ , etc., etc.) The reason that the mean is 15, in other words, is because contractions from historically-high levels (25) usually go to historically-low levels (5) rather than stopping in the middle; if they stopped in the middle, the mean wouldn't be 15 any more.

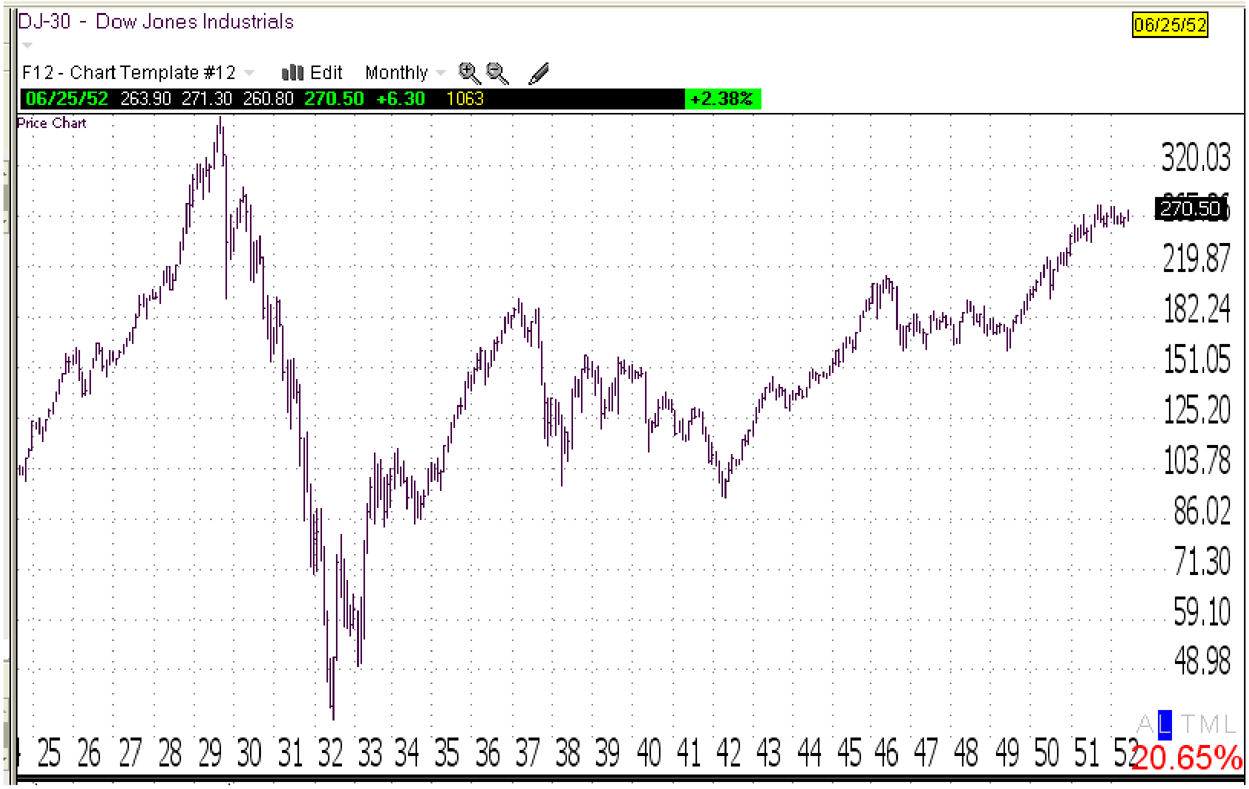
From a long-term standpoint, then, history tells us to expect a period of unusually-high multiples like the ones we saw in the last decade to be followed not by a "reversion to the mean" but, rather, by to a decline to unusually-low multiples. At this point I could write pages and pages about the secular swings from pessimism to enthusiasm and back to pessimism again and the long-term implications these swings have for investors in all kinds of financial instruments, but the only point I really want to make is that <u>the decline in all sorts of financial gauges from abnormally-high levels to more normal levels should not be expected to stop just because they've reached those more normal levels.</u> We should expect, rather, the gauges to ultimately approach equal but opposite extremes to their peak readings of the last decade.

A "Secular Revaluation Contraction"

David Fuller (FullerMoney.com, London) introduced what I thought was a terrific phrase to describe the secular decline that is now underway at this year's Contrary Opinion Forum; rather than calling it a "reversion to the mean" or "secular bear market", he termed it a "secular valuation contraction". One of the key reasons why I think David's phrase is superior is because the process is comprised more of time than price – and, as David pointed out in his October presentation which we wrote up at length for you at the time, price can hit bottom well before the secular valuation contraction ends. Here, for example, is the chart David shared with us in October illustrating the last secular valuation contraction from 1967 to 1982 when the P/E ratio fell to 8 and the yield hit 6.4%:

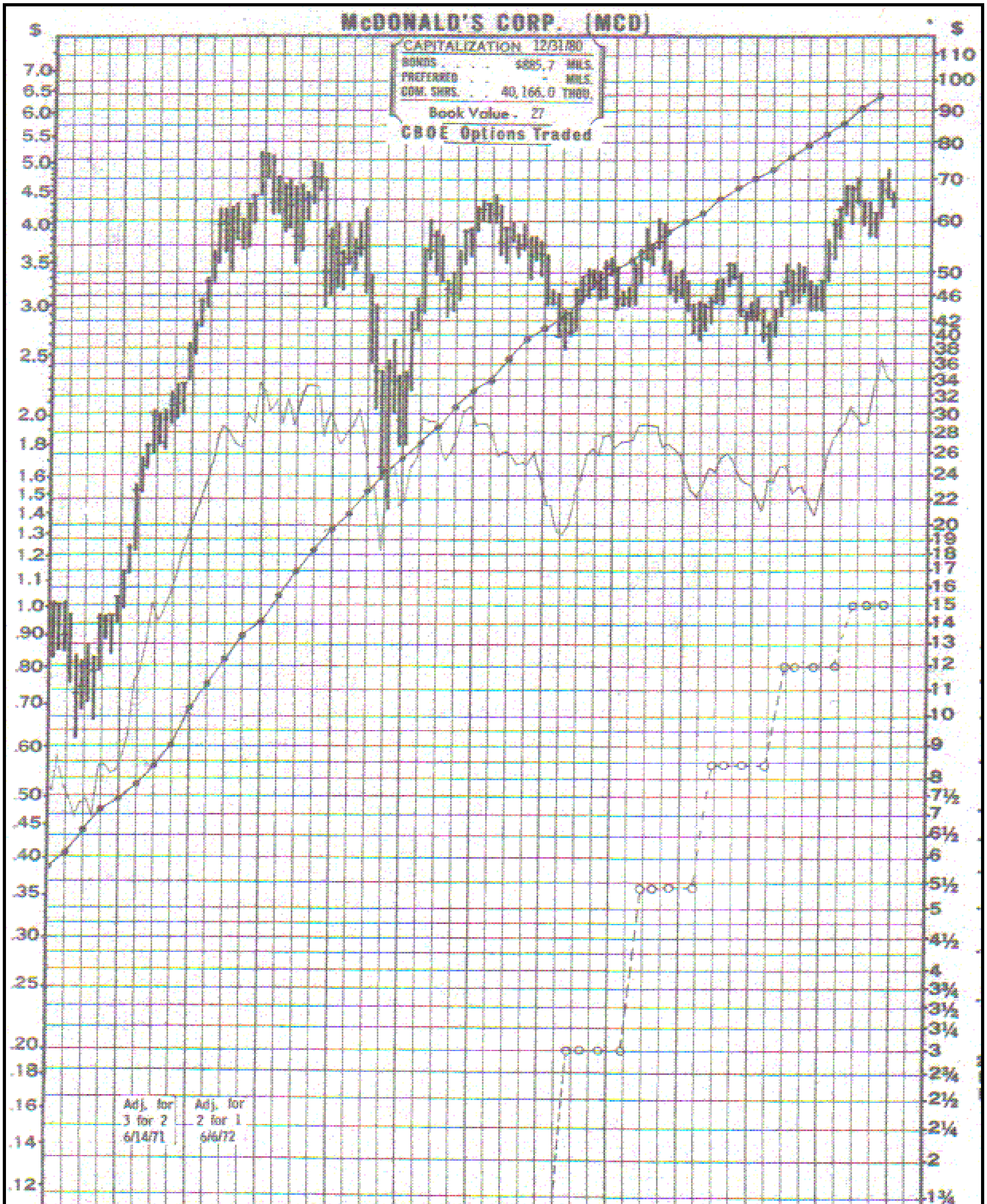



And here's a chart that shows the secular valuation contraction from 1929 through 1949, when the Dow Industrials went from a peak of 25 times earnings to an ultimate low multiple of just 6 times earnings and a yield of 6.5%:




It's important to understand that these secular valuation process/corrective processes take decades, not years, to be completed. This applies to the credit contraction/ debt unwinding process as well; as Paul Krugman recently noted: "Economies that have experienced a severe financial crisis generally don't heal quickly. From the Panic of 1893, to the Swedish crisis of 1992, to Japan's lost decade, financial crises have consistently been followed by long periods of economic distress." Money managers are thus likely to find themselves operating in this new era, with its new rules and new parameters, for a good part of the current decade. This is especially true since the deleveraging process is far from complete; again, according to Paul Krugman, although household debt has fallen to 118% of net income from its 2007 peak of 130% it is still well above its 92% level of 2000 and 83% in 1990.

Finally, before I end this reversion to the mean/secular valuation contraction discussion I wanted to publish this Securities Research Blue Book chart of McDonald's in the 1970's that shows the height and long unwinding of the Nifty Fifty growth stock era one last time. The solid line is the plot of the stock's trailing twelve-month earnings, scaled in such a way that when the price is on top of the earnings line the P/E multiple is 15. The


McDONALD'S CORP. (MCD)
CAPITALIZATION 12/31/80
BONDS $885.7 MILS.
PREFERRED - MILS.
COM. SHRS. 40,166.0 THOU.
Book Value - 27
CBOE Options Traded
Adj. for 3 for 2 6/14/71
Adj. for 2 for 1 6/6/72
'70 '71 '72 '73 '74 '75 '76 '77 '78 '79 '80 '81

in such a way that when the price is on top of the earnings line the P/E multiple is 15. The earnings line is also plotted on a log scale so that you can determine the compound growth rate; in this case it was 25% – and the company never missed a quarter.

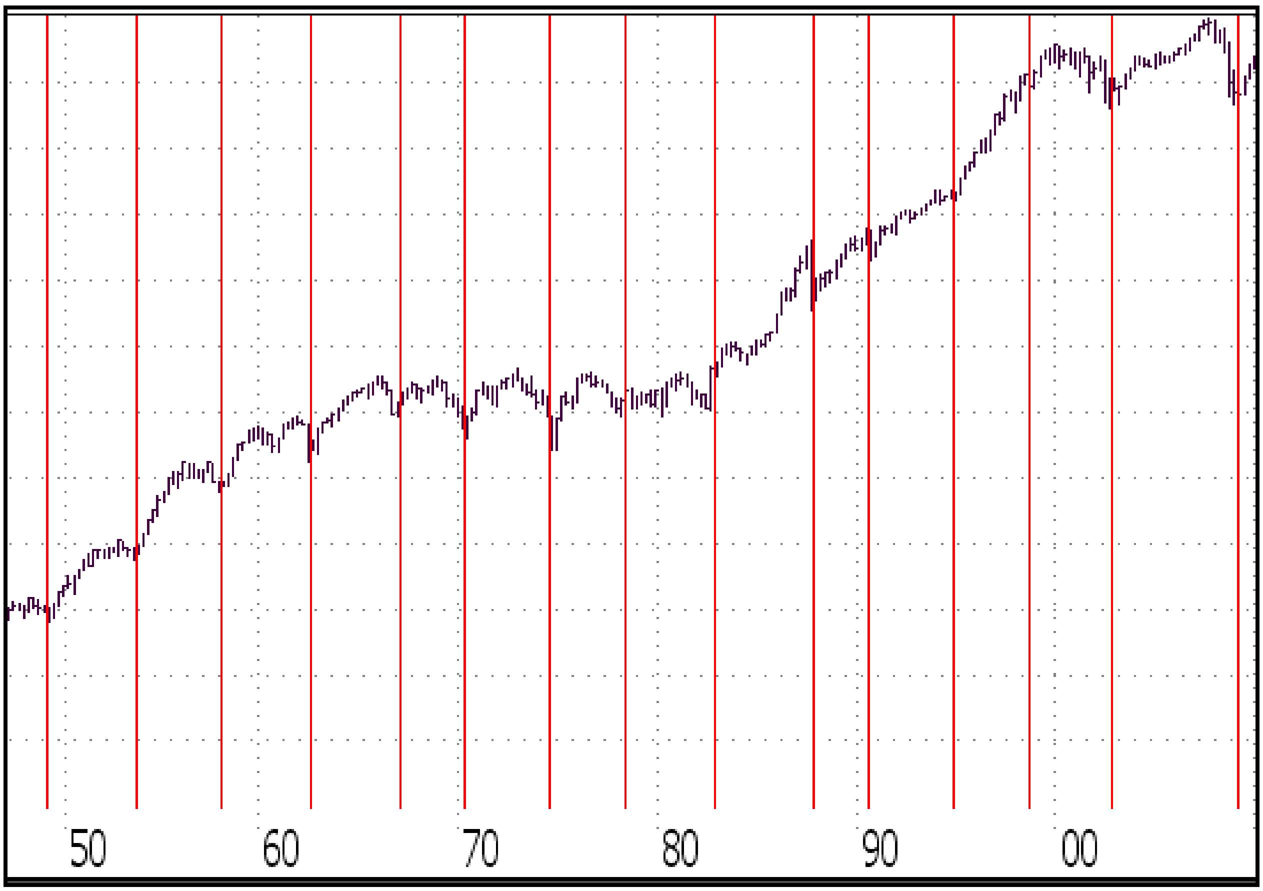
Putnam's Nifty Fifty disciples foresaw this stunning growth in 1973 and happily paid 75 times earnings for shares of McDonald's. Unfortunately, as you can see from the chart the stock didn't perform in line with the earnings and the P/E slowly but inexorably sagged from its peak of 75 to an almost-unbelievable 7½ in 1980. This, I think, is as good an illustration as any of the fact that when a data series reverts to the mean it doesn't stop simply because it reaches the mean but, rather, keeps on going until it reaches some sort of roughly-equal extreme on the other side.

(That thin line going across the middle of the chart, by the way, is a relative strength line. The decline sadly depicts the gradual but inevitable end of yet another overdone investment philosophy.)

The "Presidential Cycle" And The Four-Year Cycle

There are two widely-followed long-term cycles in the stock market: the four-year cycle and the Presidential Cycle. The latter is grounded in Machiavellian principles: the President and the Fed conspire to stimulate the economy the year before a Presidential election in order to ensure that economic conditions are the best they can possibly be on Election Day which, in turn, leads the voters to re-elect the party occupying the White House and is therefore responsible for those wonderful economic conditions. The overstimulation prior to the election is then offset afterwards by restrictive measures which dampen the economy and thus set up the next round of stimulus before the next Presidential election. This all leads to the two pre-election years being much better for the stock market than the two post-election years.

On the surface, this works out quite nicely; according to Ned Davis, the average return the year after a Presidential Election [2009] is 5.5%; it then falls to only 3.7% in the year after that [2010] when the restrictive measures are exacting their maximum toll. Then, as the political and economic masters of the universe start to unleash their magic, the average return rises to 12.6% in the pre-election year [2011] and is a still-good 7.5% in the election year itself [2012]. The Presidential Cycle thus suggests that this coming year -- 2011 -- will be a very good year for stock market investors, a fact which the uncomfortably-large number of stock market bulls have not been one bit reluctant to emphasize.




But there is a second long-term cycle to consider: the Four-Year Cycle, which can be traced back to work done by Harvard's Joseph Kitchin in 1923. It posits that the stock market makes a major low every four years or so. As you can see from the chart, this has worked remarkably well, with the stock market making major lows in 1949, 1953, 1957, 1962 (the 1961 low got pushed back a year), 1966 (which was four years after 1962 and thus put the market on a new four-year timetable), 1970, 1974, 1978, 1982, 1987 (the 1986 low got pushed back a year), 1990 (which put the market back on the old four-year timetable), 1994, 1998, and 2002.

Which brings us to the current problem. There was <u>supposed</u> to be both a Presidential Cycle low and a Four-Year Cycle low in 2006 – but the stock market did <u>not</u>

make a major low that year but, rather, took another two years, until late 2008-early 2009, to do so. The question thus becomes whether we are currently under the influence of the Presidential Cycle and the Four-Year Cycle has reverted back to its old timetable (1998, 2002, 2006, 2010...), which would set up a major low in this now-ending year, or whether the Four-Year Cycle has been pushed back a couple of years and is now on a new timetable with the next major low now not to be expected until late 2012-early 2013.

The distinction has major, major implications for long-term investors. The reason is simple: the Presidential Cycle says that the stock market was due to make a major low in 2010 and will now enjoy two years of rising prices. If the Four-Year Cycle is the dominant factor, however, and since March 2009 was clearly a Four-Year Cycle low, the next major low in the stock market is not scheduled to occur for another two years – or not until the first half of 2013. (And for those who are still trying to force a Four-Year Cycle low into 2006 and another one in 2010 – please stop. There is no way on God's Green Earth that the stock market could have made a Four-Year Cycle low in 2006 and 2010 and made a much, much lower low in late 2008-early 2009 that was <u>not</u> a Four-Year Cycle low. It's mathematically and physically impossible.)

Tops, meanwhile, are supposed to occur around midway through a cycle which, in the case of this Four-Year Cycle would be March 2011. Tops, though, are not nearly as regular as bottoms, which is why cycles are measured trough-to-trough rather than peak-to-peak. If the underlying trend is strong, the peak is "right-hand skewed" and occurs after the midpoint, but if the underlying trend is unusually weak the peak is "left-hand skewed" and occurs before the midpoint. In the present case, I would strongly argue that the underlying trend is unusually weak here, which means the top <u>could</u> occur before this coming March – and is unlikely to occur a long time afterwards.

There is obviously a huge difference between the two scenarios. The Presidential Cycle says that the stock market made a major low in 2010 and that 2011 and 2012 will be quite positive ones. The Four-Year Cycle, on the other hand, says that the stock market will make a major <u>high</u> this coming year, probably relatively early in the year, and that the outlook will be negative from then until the next Four-Year Cycle low in early 2013. One is thus forced – for the first time in a long while – to choose between the two.

Why not go with the Presidential Cycle? I think (but obviously can not prove) that the main reason that the Presidential Cycle has worked as well as it has in the past is because it was lined up with the Four-Year Cycle. The original Four-Year Cycle work, remember, was published back in 1923 and was based on data from 1890 to 1922 – before there was a Fed to manipulate the economy. There is also a four-year cycle dating back into the 19th century in English data, before our two economies were linked as closely as they are now – and the British don't hold elections every four years. This all suggests that the Presidential Cycle may well be more akin to the old Super Bowl Indicator than to the Four-Year Cycle. (And, for those who believe in it anyway, I need to point out that the stock market declined in the third year of the Presidential Cycle in 1931 and 1939; two years that are more similar to the era that we are now in than the post World War II credit-expansionary era.)

And to defend the Four-Year Cycle even further: despite the market's failure to make a major low in 2006 it still behaved rather normally from 2006-2009 in Four-Year Cycle terms (although not in Presidential Cycle terms). We noted in 2007, for example, that there had been only two prior bull market extensions prior to that one, in 1961 and 1987, and both had ended badly. (See http://www.walterdeemer.com/SP196187.pdf.) Since the 2007 extension also ended badly (to put it mildly), I think the Four-Year Cycle is still very much operative. And, since the market's behavior since March 2009 has conformed to that of a classic four-year cycle, I think that the next major stock market low should be seen – all other things being equal – sometime during the first half of 2013.

Summing Up

1. We are now in a much different investment environment that the one we all grew up in.

2. The stock market is likely to go more or less generally sideways, with big swings in both directions, for a long, long time.

3. Data series aren't going to stop "regressing to the mean" just because they've reached the mean.

4. The Four-Year Cycle is going to win the conflict with the Presidential Cycle. This will result in a major high this coming year and a major low in early 2013.


The Market Now. Earlier this month I noted that a number of warning flags were flying; among other things, the market was overbought and public option buyers were buying calls at an unprecedented pace – a contrary danger sign if ever there was one. And it wasn't just me; some of the analysts whom I respect the most, such as the folks at Lowry's and Jason Goepfert at SentimenTrader.com, were reporting troublesome developments from their vantage points as well. When I began my holiday break, then, I left you with the thought that most – if not all – of the traditional year-end rally had already been seen.

So what did the market do? Nothing but up! In fact, I'd use the "Damn the torpedoes, full speed ahead!" quote here except that the volume and upside momentum haven't exactly been at full speed-ahead levels recently. Day after day, though, the market has inched ever higher as selling pressure has been virtually non-existent.

The intermediate-term situation hasn't changed, though. The warning flags, per Lowry's and SentimenTrader.com, are still flying and the market, obviously, is still overbought. Sooner or later, this will all exact its traditional toll, as it always does. The first sign will probably come via a break of the S&P's trend-defining 13-day moving average, currently 1247.91 – but until that happens, the trend will remain up.

That move below the 13-day moving average, though, would still signify nothing more momentous than a short-term reversal of trend; it would take a close below 1173 to indicate that the market is staging a significant decline, and the cushion that's built up during the past couple of weeks suggests that the market is probably going to be able to work off its overbought condition without breaking 1173. One of the key indicators in the significant/not significant decline decision will be the percentage of Fidelity's sector funds that are outperforming cash; it's been 100% for four straight weeks now, and would have to drop below 66% to indicate that the decline-to-work-off-the-overbought-condition has more than just short-term implications. (I am, not incidentally, going to maintain and continue to report on this work following my retirement.)

As you have seen in our foregoing Four-Year Cycle discussion, though, there is every reason to believe that the market will make an important top this coming year – most probably earlier than later. (Citigroup strategists, in fact, make the case that the 2011 high could be made on January 3rd and the market could then decline 5% in January and 16% for the year in an incredibly-contrary piece you can read here: [http://pragcap.com/if-past-is-prologue](http://pragcap.com/if-past-is-prologue). As a matter of fact, this is just about the only bearish forecast I've seen in the tidal wave of bullish prognostications currently being issued – on the heels of an 89% two-year advance – which is enough to give any card-carrying contrarian like myself pause.) My earlier forecast thus still stands: the S&P is in the process of making some sort of longer-term top above 1173, and 2011 and 2012 are likely to be generally-down years. In addition, those unusually-high longer-term risks continue to make shorter-term risks higher than they would otherwise be. Until that 13-day moving average is broken, though, the trend will remain up, warning flags or no warning flags.

Fidelity Sector Funds. Our Fidelity sector fund relative strength work remained at a maximum-positive 100% for the fourth straight week this week, and it has to fall below

66% to generate a sell signal. The positions in our switching program, meanwhile, are unchanged from last week: the #1 Energy Services fund, #2 Automotive and #15 Computers. (Gold triggered one of our sell criteria last week; it was therefore sold and the proceeds redeployed into the highest-ranked fund not already owned: Energy Services.) Finally, this week's top funds are Energy Services and Automotive and the bottom funds are Money Market, Consumer Finance and Utilities.

For those of you who have asked to be put on the distribution list for our post-retirement comments and observations, by the way, I'm going to continue to calculate and report on the Fidelity sector fund strength ratings after January first. Our switching program has a performance record that makes it well worth keeping up; although it has lagged just a bit behind the S&P this year (as of last night our switching program was up 11.3% vs. a 12.8% gain in the S&P) it was up 9.7% more than the S&P in 2009 and outperformed it by 12.3% in 2008. In addition, the percentage of funds outperforming cash is one of the best intermediate/long-term indicators I know of. Like me, then, this work is not going to quite disappear completely into the sunset.

And Finally... These past 30½ years have certainly been quite an adventure. For those of you who are parting ways with me here, may I just say that without you I could have never realized my impossible dream and reached that unreachable star. I will be eternally grateful to you for making it possible, and no words can adequately convey my appreciation to you. And for those of you who have asked to receive my post-retirement comments and observations – well, I happen to think that our adventures and market explorations will scale new heights as I move into what I trust will be a kinder and gentler era.

*-- Walter Deemer*

| FIDELITY | PRICES (in cents) | | | | | DTR STRENGTH RATINGS | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| SECTOR FUND | Dec 29 | Dec 22 | Dec 15 | Dec 8 | R/C | Dec 29 | Dec 22 | Dec 15 | Dec 8 | Dec 1 |
| Energy Serv | 7421 | 7374 | 7146 | 7131 | -13 | 253 | 265 | 227 | 220 | 207 |
| Automotive | 4509 | 4521 | 4405 | 4385 | -55 | 216 | 271 | 249 | 217 | 204 |
| Nat Resource | 3473 | 3429 | 3325 | 3298 | -24 | 203 | 228 | 191 | 170 | 154 |
| Energy | 5218 | 5164 | 5002 | 4977 | -24 | 200 | 223 | 181 | 164 | 152 |
| Materials | 6785 | 6724 | 6535 | 6467 | -17 | 178 | 195 | 163 | 141 | 140 |
| Chemicals | 9533 | 9427 | 9176 | 9133 | -10 | 176 | 186 | 153 | 138 | 142 |
| Indust Equip | 3397 | 3400 | 3320 | 3267 | -34 | 158 | 192 | 163 | 135 | 110 |
| Electronics | 4819 | 4825 | 4704 | 4810 | -26 | 152 | 178 | 167 | 209 | 147 |
| Industrials | 2369 | 2374 | 2324 | 2294 | -27 | 138 | 165 | 139 | 114 | 101 |
| Technology | 9588 | 9607 | 9439 | 9533 | -31 | 132 | 163 | 149 | 166 | 149 |
| Comm Equip | 2652 | 2650 | 2568 | 2555 | -15 | 121 | 136 | 111 | 117 | 94 |
| Software | 8791 | 8799 | 8715 | 8689 | -26 | 120 | 146 | 139 | 145 | 123 |
| Natural Gas | 3315 | 3274 | 3217 | 3193 | -11 | 120 | 131 | 112 | 88 | 75 |
| Constr/Hous'g | 3506 | 3526 | 3383 | 3387 | -32 | 115 | 148 | 104 | 89 | 42 |
| Computers | 5658 | 5664 | 5544 | 5628 | -28 | 113 | 141 | 124 | 140 | 139 |
| Healthcare | 12544 | 12583 | 12406 | 12068 | -20 | 110 | 130 | 121 | 90 | 77 |
| Consumer Discr | 2455 | 2474 | 2426 | 2460 | -31 | 109 | 141 | 131 | 149 | 139 |
| Medical Equip | 2778 | 2790 | 2758 | 2647 | -34 | 107 | 141 | 167 | 83 | 70 |
| IT Services | 2120 | 2106 | 2107 | 2102 | -9 | 106 | 116 | 129 | 110 | 94 |
| Retailing | 5370 | 5403 | 5311 | 5359 | -31 | 104 | 135 | 132 | 141 | 127 |
| Banking | 1859 | 1852 | 1758 | 1744 | -26 | 101 | 127 | 68 | 44 | -15 |
| Medical Del | 4977 | 4979 | 4906 | 4855 | -20 | 97 | 117 | 120 | 111 | 101 |
| Environmental | 1784 | 1793 | 1756 | 1736 | -24 | 92 | 116 | 86 | 61 | 54 |
| Transport'n | 5522 | 5530 | 5435 | 5472 | -8 | 89 | 97 | 87 | 89 | 114 |
| Multimedia | 4288 | 4306 | 4228 | 4213 | -17 | 89 | 105 | 95 | 95 | 94 |
| Biotech | 7389 | 7460 | 7120 | 6964 | -21 | 89 | 110 | 48 | 23 | 13 |
| Leisure | 9124 | 9200 | 8924 | 9206 | -31 | 88 | 119 | 94 | 139 | 141 |
| Gold | 5302 | 5157 | 5250 | 5252 | -25 | 87 | 112 | 164 | 132 | 125 |
| Pharmaceutical | 1239 | 1238 | 1236 | 1204 | -8 | 87 | 94 | 97 | 57 | 41 |
| Broker/Invest | 5255 | 5270 | 5036 | 5055 | -22 | 85 | 107 | 60 | 46 | -4 |
| * * S&P 500 | 125978 | 125884 | 123523 | 122828 | -19 | 81 | 100 | 80 | 68 | 56 |
| Defense/Aero | 7324 | 7345 | 7270 | 7269 | -15 | 79 | 94 | 74 | 74 | 81 |
| Financial | 6169 | 6145 | 5844 | 5821 | -16 | 78 | 94 | 38 | 11 | -60 |
| Consumer Stpls | 6836 | 6838 | 6725 | 6674 | -15 | 76 | 91 | 71 | 59 | 52 |
| Telecommun | 4626 | 4614 | 4625 | 4543 | -9 | 74 | 83 | 99 | 77 | 72 |
| Insurance | 4722 | 4735 | 4630 | 4586 | -21 | 69 | 90 | 64 | 41 | 39 |
| Airlines | 4229 | 4235 | 4181 | 4219 | -6 | 68 | 74 | 61 | 69 | 109 |
| Wireless | 766 | 768 | 757 | 751 | -18 | 63 | 81 | 81 | 65 | 60 |
| Utilities | 4847 | 4844 | 4721 | 4711 | -5 | 57 | 62 | 31 | 13 | 22 |
| Consumer Finance | 1139 | 1130 | 1114 | 1115 | -8 | 41 | 49 | 29 | 14 | -23 |
| * * T Bills | 1985 | 1985 | 1985 | 1985 | 0 | 0 | 0 | 0 | 0 | 0 |