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## **A LONG MARKET CONVALESCENCE**

### **The Easy Part of the Recovery Is Behind Us**

I introduced the notion of a “W” economic scenario and its implications for the stock markets in February 2009, as the economy was still in recession and the global stock markets were only approaching their March lows ([The Economic Alphabet Game](#) – 2/13/2009).

As contrarian investors, who were becoming more favorably biased toward the markets, we were faced with a puzzle.

On the one hand, the markets’ declines from their highs had already matched those of earlier bear markets associated with economic recessions – both in length and in amplitude – and the investment crowd had become overwhelmingly negative -- the kind of capitulation that usually accompanies market bottoms.

On the other hand, it was clear that the economic and financial imbalances built during the previous decade or more could not be mended in one year or even in a single economic cycle. A (very) few enlightened and sober-minded economists were pointing to signs of an approaching economic recovery. But longer-term, looking to an extended period of deleveraging by consumers and homeowners (close to three quarters of the American GDP), together with a still-largely dysfunctional financial system, one could not reasonably expect the fragile economy to be back to normal for quite some time.

On top of that, while market psychology gave fairly clear signs of paralysis, if not panic, stock market *valuations* – possibly with the exception of Japan – were far from their historical bear market lows. In fact, price/earnings ratios were merely back to their very long-term averages and, as I reminded readers ([Negotiating The “W”](#) – 8/6/2009), they had never stopped in the past there and, instead, always went on to new lows before the onset of new secular bull markets.

But, as I also pointed out, new *valuation* lows do not necessarily imply new *price* lows. A “W” scenario would give time to the economies to slowly and irregularly mend, while it would also allow valuations to decline further – possibly through a combination of *some* price correction from the forthcoming initial recovery high and the corporate earnings recovery gaining momentum.

Throughout 2009, I did not write much as I had little to add to this analysis. In my August update, however, I suggested that a bounce toward 1100 “or even a bit higher” for the S&P 500 Index would be a credible target for the initial recovery high, as it would erase the abnormal market panic that had followed the Fall of 2008 failures of several major financial institutions. That would seem like a good time to reassess the potential of the stock markets going forward.

And here we are -- at 1145 on the S&P 500 Index, with most economists now acknowledging the economic recovery though still unsure about the longer-term outlook; analysts typically busy raising

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their profit estimates apace with the booming stock prices; and chartists and momentum players projecting the recent past into the future in the form of further progress in stock prices. I anticipate that a market correction cannot be too far off... but it is both more challenging and more interesting to look a little further down the road.

### **What Happens After Secular Bear Markets**

Last August, Morgan Stanley’s European research team published a report entitled “The Aftermath of Secular Bear Markets”. Contrary to what I have preferred in the past, they did not measure secular bear markets in terms of stock valuations, but more traditionally in terms of simple stock prices. They analyzed the profile of “19 major secular bear markets, including the US in the 1930s, the US and Europe in the 1970s, Gold in the 1980s. Each involved a peak-to-through decline of at least 40% lasting at least a year”. In my view, a year falls somewhat short of the “secular” definition, but let’s not nitpick, especially since the median of these bear markets showed a 57% decline over 30 months – arguably important enough to pay attention.

The *median* of a sample is the figure that has an equal number of observations above and below it. Arguably, therefore, it is more representative than an *average*, which can be heavily distorted by extraordinarily large or small numbers. Nevertheless, I am reminded that it is dangerous to try and cross a river with an “average” (or even a “median”) depth of 5 feet...

In any case, the pattern observed in many bear markets’ aftermaths is more interesting than any precise measurement. Typically, major bear markets tend to be followed by a powerful rebound (which we have just had), itself followed by some downward correction and then a period of consolidation when the market oscillates within a rather broad, flattish channel – often for several years. That pattern is pretty well illustrated by the following chart of the S&P 500 in the mid-late 1970s.

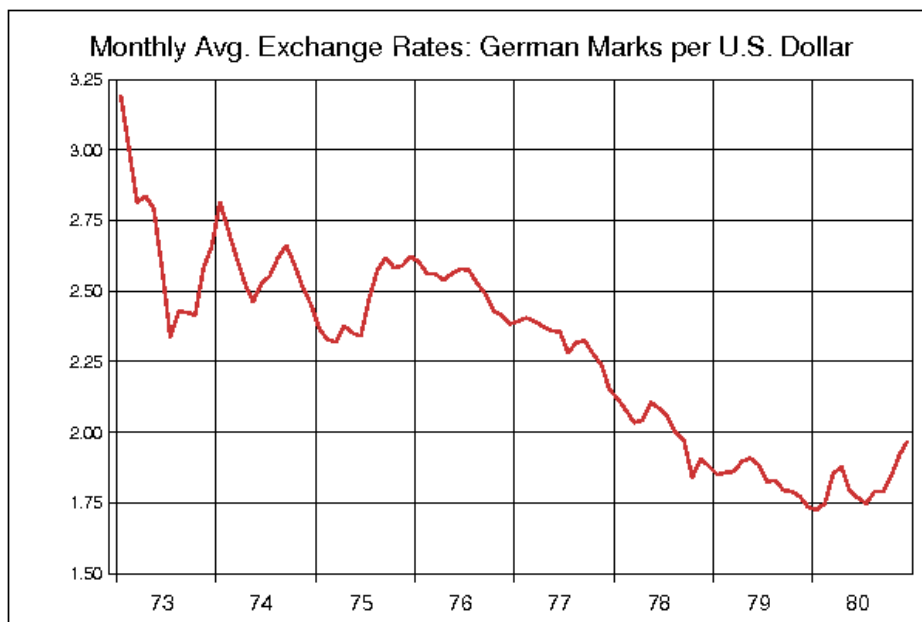




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Lest one should be tempted to assume that things are much worse or complex today than in similar, past episodes, we should recall that, in the mid-1970s -- only a few years after some leading economists proclaimed that we had conquered the economic cycle and would never again have to confront a severe recession -- the world economy was emerging from the first globally-synchronized and most severe recession since the 1930s.

The United States, for its part, was thoroughly demoralized and divided by the Watergate scandal and the forced resignation of President Nixon (1974), as well as by its military defeat in Vietnam (1975). A further humiliation was the steady fall of the dollar after the collapse of the dollar-based Bretton Woods monetary system and the floating of the major currencies (1973).



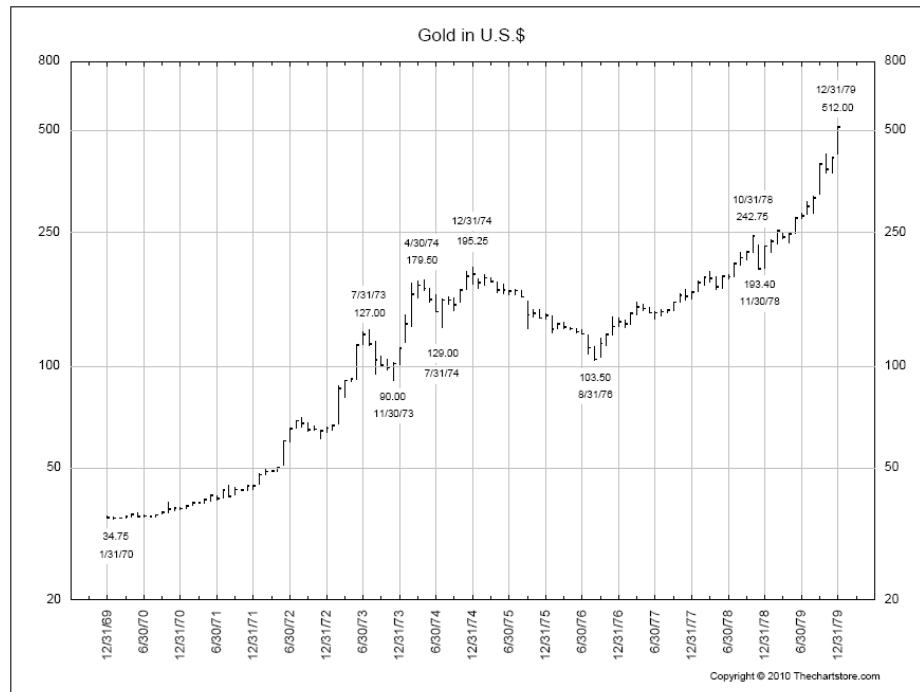
Pacific Exchange Rate Service – Prof. Werner Antweiler, University of British Columbia

Probably helped by this devaluation, large oil-producing nations formed the Organization of Petroleum Exporting Countries (OPEC) in 1973 and instituted an embargo that resulted in a quasi-instantaneous quadrupling of oil prices, from a bit over \$3 per barrel in 1972 to over \$13 a barrel in the mid-70s. By the end of the decade, they would be more than six times their 1972 level. Of course, such a large and sudden jump in the price of an essential and broadly used commodity was bound to exacerbate the nascent inflationary tendencies. But, perversely, to the extent that the demand for oil is rather insensitive to price in the short or medium term, it also was deflationary, acting as a massive tax on the world economy, and thus depressing demand for other goods and services.

Gold, of course, did its thing, steadily rising from a price of less than \$35 in early 1970 to \$512 at the end of 1979 (on its way, briefly, to \$800).



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The loss of power and control by the United States was further evidenced by the vertiginous expansion of the Eurodollar market, a market largely based in London where foreign banks and offshore affiliates of U.S. banks lent and borrowed dollars to each others. Some eastern European banks had started, early in the cold war, to trade dollars obtained from U.S. trade deficits, to avoid the risk of confiscation by the United States. Initially, the market had remained subdued and hardly noticed. But in the 1970s, with U.S. deficits gaping and under the added impetus of large and sudden OPEC surpluses that initially proved hard to recycle, the market exploded and probably could be counted in trillions of dollars (real money at the time) by decade end.

At that size, the Eurodollar market represented a great, though unquantifiable danger for the financial system because its banks operated outside the Federal Reserve’s control (or that of any central bank for that matter). For example, there were no compulsory reserve requirements: not only did this render the traditional tools of monetary policy increasingly ineffective in fighting inflation, but total uncertainty reigned as to which central bank would have to intervene in the eventual failure of a large institution. There was no obvious lender of last resort in case of a financial crisis developing in the Eurodollar market.

In 1976, with the enthusiasm of a still-youngish analyst, I produced a long report entitled “Between Inflation and Deflation: The Dislocating World Economy”, which more or less depicted this sad state of affairs. Our senior partner at Tucker Anthony, previously a prestigious banker, commented the next morning: “I read your opus, last night: very stimulating, but I would not sell America short just yet”. I like this anecdote because it confirms the forecasting superiority of common sense and experience over purely technical skills.



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## **The Temptation of Doom**

In an article of which I lost the source, the author (who may have been famous investment strategist Barton Biggs) explains that bears generally seem to have the most compelling arguments.

Their points seem plausible, level-headed, empirical and reasonable, while bulls come across as starry-eyed idealists... Bears get to argue from data, while bulls argue from what might happen. Most bearish arguments assume that people cannot adjust, problems cannot be addressed, and things will go on pretty much as they have. And yet, many problems get solved.

I mention this comment because I am afraid that my analysis in this paper may seem discouraging to clients. The “W” scenario may unfold; it would likely trigger stock market corrections; and these may even be followed by a few years of consolidation with few net investment gains. But these travails may only be the prelude to the next great bull market.

In the dour days of the 1970s, few people imagined how prosperity could return to America. Yet great creativity was at work behind the scenes, inventing a new economy. Even as “offshoring” and the emergence of new competitors abroad were threatening to depress manufacturing employment in mature economies, old industries were already looking at ways to restructure and become more productive, while major new industries were being born.

The “dark” 1970s saw the birth of many technologies that would provide whole new employment and revenue opportunities for years to come. Among them: the microprocessor; the computer floppy disk; liquid crystal displays (LCDs); the CAT scan; the cellular phone battery; spreadsheets; e-mail; the VCR and the digital camera. At the same time brand new companies such as Microsoft, Apple Computers, Oracle, Fedex, Genentech and Nike were founded that would become among the most successful in the world. Also, the heretofore relatively confidential venture capital industry experienced a momentous expansion in the 1970s, which provided the capital needed by all these nascent industries and companies. All in all, according to author George Gilder citing an MIT study, this creative turmoil was reflected in the fact that companies with less than 100 employees created 80% of the net new jobs in the American economy throughout the 1970s.

## **Conclusion**

The aftermath of the Great Recession and bear market we have just experienced may look like a long rollercoaster ride, with a plethora of yet-unsolved problems and aftershocks of the financial crisis. But, in all likelihood, it may also be a period of increasing opportunity, especially when markets oblige by suffering periodic corrections.

**François Sicart** (in Mexico)

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