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Mr. Market Goes Off His Meds and Becomes Depressed

By Christopher D. Rich, CFP®

I wrote in my last commentary on August 8th about Mr. Market and that this "person" is a manic-depressive. Mr. Market vacillates between various states of mania, good health, and depressive. When he is depressed pessimism reigns. The future is bleak and stock assets appear way too expensive to him. He will only pay low prices for businesses. Back in August, I mentioned that I felt Mr. Market had moved from a manic phase to a healthy state, but we expected at some point he would move to a depressed state. Are we there now?

Tune Out Fear and Focus on Value

The economic outlook is dreary. Unemployment is high, economic growth is slowing here in the US, Europe is in recession territory and dealing with a pending Greek debt default, and we are seeing cracks in the endless growth prospects of China. Environments like this cause Mr. Market to be depressed. But when we look beyond the headlines, we are starting to see prices of some of the great businesses of the world move to bargain prices. For those of you that may have missed my last discussion, I reviewed the difference between price and value. Price is subject to the winds that blow. Value, on the other hand, is much more stable and is defined as the present value of all the earnings the owners can expect to have delivered to them over the life of the business. We can never know how depressed Mr. Market will become and how long his depression will last, but we can make reasonable assessments about value. Our own thesis outlining our expectations for the next several years is attached for those that would like to review it. However, one of the key points of our thesis is that we expected to see a contraction in the multiple investors would be willing to pay for a dollar of normalized earnings. It appears we are starting to see that contraction take place now.

Stop the Presses: Bargains Ahead

As of this writing, the S&P 500 is down nearly 20% from its peak on April 29th. International developed economy stocks, as measured by the EAFE Index, are down more than 25%, and international emerging market stocks are off more than 30%. The firm GMO LLC out of Boston makes a 7-Year forecast for various market returns. The firm uses an average of 7-years of earnings and then assumes that markets will return to their long-term fair value multiple over a 7-year market cycle in making their calculation. I've adjusted their August month-end calculations to reflect the additional market decline through 10/3/11.

Adjusted GMO 7-Year Asset Class Average Annual Return Forecasts

US Large Company	**5.9%**
US Small Company	**5.8%**
US High Quality Dividend	**9.2%**
Int'l Large Company	**10.8%**
Int'l Emerging Market	**13.1%**

As you might expect, we are pleased to see that expected returns for foreign stocks over the next 7-years are above their long-term average based on stocks in those markets trading below fair value. In addition, US high quality dividend stocks are within "arms length" of reaching fair value.

Navigating From Here

Unfortunately, a 7-year forecast does not tell us the pattern of Mr. Market's mental illness and when he will go back on his meds. Thus, expect to see additional volatility. Also, expect that we are likely early and markets may have further downside before stabilizing and turning up. Given those expectation, we are tip-toeing back into low priced markets and will become more aggressive as prices drop further. For those of you with cash or alternative investments available, we expect to become cautious buyers in these under-priced areas over the next several weeks to months as we see compelling entry points. Likewise, we are modifying our 4 Lean Years scenario in our retirement planning projection reports to 2 Lean Years reflecting better market pricing.

Our Economic and Market Thesis

- **There is a soft spot in global aggregate demand for goods and services:**
    - **Baby Boomers are aging – first one turned 65 this year**
    - **Middle Class Debt Reduction – 4 more years at current trajectory**
    - **Echo Boom (Baby Boomer children) not fully entering the economy – much more spread out demographically than the Baby Boomers**
    - **Excess supply of housing stock – 12 to 18 months more at current absorption rate**
    - **Emerging economies of China, India, and Brazil are 35%-40% export driven – 5 to 10 more years of growth to build their middle classes to drive global aggregate demand**
    - **Economic growth will be 1%-2% lower than average for 3-7 years as we work through the above items**
    - **Federal Reserve is "boxing-in" investors to take risk in order to support asset prices as it attempts to stimulate the economy**

        - **Corporate reduction of expenses is not the same as organic revenue growth – profit margins on S&P 500 companies at 50% above their long-term average.**
        - **Global economy is confronted with an unusual number of large economic issues**
    - **This will cause:**
        - **Additional market volatility**
            - **As economy appears to gain traction and then doesn't**
            - **As investors adjust to the "New Normal"**
            - **As traders vacillate between a "risk on" and "risk off" trade due to Fed intervention**
        - **A contraction in the multiple that investors are willing to pay for a dollar's worth of "normalized" earnings, punctuated by cyclical rallies within the secular bear market.**
    - **U.S. stocks have moved from <u>heavily</u> overpriced in April of this year to <u>moderately</u> overpriced**
    - **Global stocks, due to lower valuation starting point and a larger decline, have moved from <u>heavily overpriced</u> to <u>moderately underpriced</u> -- allowing investors for the first time since 2002 (except for 45 days in March/April 2009) to build a moderately underpriced globally diversified stock portfolio**
    - **New secular bull markets have historically been born on markets that trade at 30-50% below the normalized P/E (10 year) of 17 – current S&P 500 P/E10 is about 19 (down from over 22 in April)**
    - **Current secular bear market is in the 6th – 7th inning and still has 3 – 7 years to go that will be characterized by cyclical bear market rallies and declines.**
    - **We are positioned somewhat more defensively anticipating the opportunity to continue to deploy low risk capital (bonds and alternatives) into equities as prices become increasingly attractive.**
    - **Strong but not certain probability that we are in or entering a second recession (double-dip)**