Biiwii Commentary

***e*Research Corporation** is pleased to provide an article, courtesy of Biiwii.com, and written by Heisenberg, with a link provided to its website.

The article, starting on the next page, is entitled: **"Is This Bubble Smaller Than We Thought?"**

Biiwii.com was created in mid-2000 solely as a way to help get the message out about deeply-rooted problems about too much debt and leverage within the financial system. The concerns were confirmed and the message proved justified 3 to 4 years later as the system began to purge these distortions, resulting in a climactic washout extending from October, 2008 to March, 2009.

Along the way, a geek-like interest in technical analysis, a long-time interest in human psychology, and various unique macro market ratio indicators were added to the mix, with the result being a financial market newsletter (and dynamic interim updates), Notes From The Rabbit Hole (NFTRH) that combines these attributes to provide a service that is engaged and successful in all market environments by employing risk management first, and opportunity for speculation second.

But It Is What It Is: You can access Biiwii at its website: **www.biiwii.com**.

Notes From The Rabbit Hole: You can access NFTRH at its website: **www.NFTRH.com**

***e*Research** was established in 2000 as Canada's first equity issuer-sponsored research organization. As a primary source for professional investment research, our Subscribers (*subscription is free!!!*) benefit by having written research on a variety of small- and mid-cap, under-covered companies. We also provide unsponsored research reports on middle and larger-sized companies, using a combination of fundamental and technical analysis. We complement our corporate research coverage with a diversified selection of informative, insightful, and thought-provoking research publications from a wide variety of investment professionals. We provide our professional investment research and analysis directly to our extensive subscriber network of discerning investors, and electronically through our website: www.eResearch.ca.

Bob Weir, CFA
Director of Research

Note: All of the comments, views, opinions, suggestions, recommendations, etc., contained in this Article, and which is distributed by *e*Research Corporation, are strictly those of the Author and do not necessarily reflect those of *e*Research Corporation.

Is This Bubble Smaller Than We Thought?

By **Michael Ashton**

There is nothing tantalizing about stocks, other than the possibility that the downside is perhaps not as bad as I have been fearing.

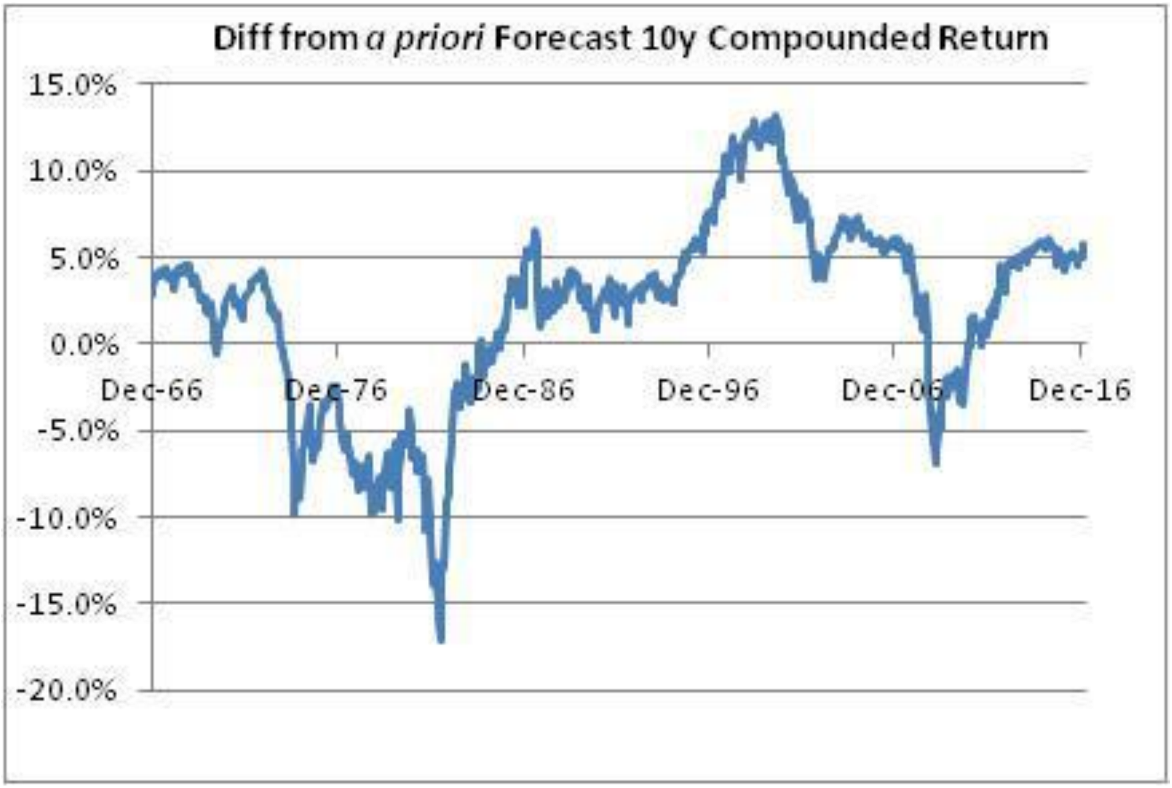
Today, I want to revisit something I wrote back in December about the stock market. In an article entitled "Add Another Uncomfortable First for Stocks," I noted that the expected 10-year real return premium for equities over TIPS was about to go negative, something that had not happened in about a decade. In fact, it *did* go slightly negative at the end of February, with TIPS guaranteed real return over ten years actually slightly *above* the expected (risky) real return of equities over that time period. At the end of March, that risk premium was back to +3bps, but it is still roughly the same story: stocks are priced to do about as well as TIPS over the next decade, with the not-so-minor caveat that if inflation rises TIPS will do just fine but stocks will likely do quite poorly, as they historically have done when inflation has risen.

But I got to wondering whether we can say anything about the current market on the basis of how far stocks have out-performed the *a priori* expectations. That is, if we made a forecast and a decade goes by and stocks have shattered those expectations, does that mean that the forecast was bad or that stocks just became overvalued during that period so that some future period of under-performance of the forecast is to be expected? And, vice-versa, does an under-performance presage a future out-performance?

The first thing that we have to confess is that the way we project expected real returns will not produce something that we expect to hit the target every decade. Indeed, the misses can be huge in real dollar terms – so this is not a short-term or even a medium-term trading system.

Consider the following chart (Source: Enduring Investments), which shows the difference of the actual 10-year return compared with the *a priori* forecast return from 10 years prior. A positive number means that stocks over the period ending on that date out-performed the *a priori* forecast; a negative number means they under-performed the forecast.

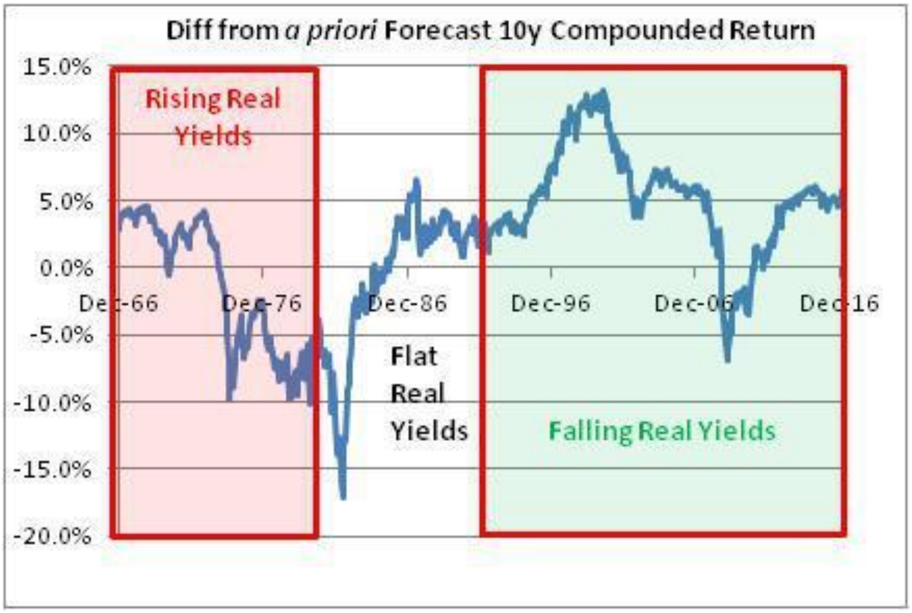
In context: a 5% per year miss in the real return means a 63% miss on the 10-year real return. That is huge.



What you can really see here is that stocks have – no surprise – very long 'seasons' of bear and bull markets where investors en masse are disappointed with their returns, or excited about their returns.

But let me update this chart with an additional observation about real yields. During the period covered by this chart, there have been three distinct real yield regimes. In the 1960s and 1970s, real yields generally rose. In the late 1970s, 10-year real yields rose to around 4.25%-4.50%, and they did not begin falling again in earnest until the late 1980s. (This is in contrast to nominal yields, which started to fall in the early 1980s, but that was almost entirely because the premium for expected inflation was eroding). Between the late 1970s and the late 1980s, real yields were more or less stable at a high level; since the late 1980s they have been declining.

In the following chart (Source: Enduring Investments), I have annotated these periods and you may reasonably draw the conclusion that in periods of rising interest rates, stocks under-perform *a priori* expectations in real terms, while in periods of falling real interest rates, stocks out-perform those expectations.



These rolling 10-year rate-of-change figures are interesting but it is hard to see whether periods of out-performance are followed by under-performance etc. It doesn't look like it, except in the really big macro picture where a *decade* of out-performance might set the stage for a *decade* of under-performance.

I like the following look at the same data. I took the *a priori* 10-year real return forecast and applied it to the then-current real price level of the S&P 500 (deflated by the CPI). That produces the red line in the chart below (Source: Enduring Investments). The real price level of the S&P is in black. So the red line is the price level forecast and the black line shows where it ended up.

As I said, this is not a short-term trading model! It is interesting to me how the forecast real level of equities did not change much for a couple of decades – essentially, the declining market (and rising price level) saw the under-performance impounded in a higher forecast of future returns. So the “negative bubble” of the 1970s is readily visible, and the incredible cheapness of stocks in 1981 is completely apparent. But stocks were *also* cheap in real terms in 1976…it was a long wait if you were buying then because they were cheap. Value investing requires a lot of patience. Epic patience.

However, once equity returns finally started to outpace the *a priori* forecast, and the actual line caught up with the forecast line, the market leapt higher and the twin bubbles of 1999 and 2006 are also apparent here (as well as, dare I say it, the current bubble). But since the forecast line is climbing too, how bad is the current bubble? By some measures, it is as large or nearly as large as the 1999 bubble. But if we take the difference between the black line and the red line from the prior chart, then we find that it is possible to argue that stocks are only, perhaps, 30% overvalued and not as mispriced even as they were in 2006.

This may sound like slim solace, but if the worst we have to expect is a 30% retracement, that is not really so terrible – especially when you realize that that is in real terms, so if inflation is 3% per year then you are looking at a loss of 10-15% per year for two years.

That is almost a yawner.

On the other hand, if we are entering an up-cycle for real interest rates, then the downside is harder to figure. In the last bear market for real yields, stocks got 60% cheap to fair!

None of this is meant to indicate that you should make major changes in your portfolio now. If all of the evidence that stocks are rich has not caused you to make alterations before now, then I would not expect this argument to do it! Rather, this is just a different rationality-check on the idea that stocks are over-valued, and my words could actually be taken as soothing by bulls.

The chart shows that stocks can be over-valued, and out-perform *a priori* expectations that incorporate valuation measures, for *years, even decades*. Maybe we are back in one of those periods?

But we have to go back to the very first point I made, and that is that if you don't feel like betting the 30% over-valuation is going to get worse, you can lock in current real return expectations with zero risk and give up nothing but the tails – in both direction – of the equity bet. The equity premium, that is, is currently zero and stocks are additionally exposed to rising inflation. I see nothing tantalizing about stocks, other than the possibility that the downside is perhaps not as bad as I have been fearing.

Biiwii/NFTRH on the Web

NFTRH and Biiwii.com commentary and technical analysis have regularly been published, highlighted and/or quoted at SeekingAlpha, Investing.com, MarketWatch, Yahoo Finance, Ino.com, TalkMarkets and many more since 2004.

Biiwii.com is proud to be included in the **50 Blogs Every Serious Trader Should Read** from TraderHQ.com.

Biiwii: But it is what it is

NFTRH: Notes From The Rabbit Hole