

## Investing in Range-bound Markets

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In the bull market that preceded the collapse of Lehman Brothers and the financial crisis, equity valuations reached some very frothy levels.

The correction that followed lasted only until March, and since then the S&P 500 index and the FTSE Eurofirst 3000 have risen more than 60%. Even in spite of the post-Lehman correction, equity markets have been in a secular range-bound phase since 2000.



Investors must understand the dynamics of range-bound markets and the best ways of investing in such an environment.

### Secular market cycles

Let me lay out my thesis for secular (long-term, longer than five years) market cycles.

Ask an investor what the stock market will do over the next decade, and he'll tell you his expectations for the economy and earnings growth, and that will turn into his projection for the market. However, this kind of thinking looks at the half of the equation that explains stock market (and individual stock) returns, while completely ignoring a very important variable that is responsible for a significant part of stock returns: valuation.

Mathematically, stock prices in the long run (not minutes or days, but years) are driven by two factors: earnings growth and (it's a very important *and*) changes in valuation (P/E ratios). Once you add a return from dividends, you've captured all the variables responsible for *total* return from stocks.

During the last two centuries, every time we had a long-lasting bull market the market what followed was not a bear but a range-bound, sideways market. (The only notable exception was the decline during the Great Depression.) This happened not because of some hidden, embedded magical pattern. No, there is no practical joke being played on gullible humans; it happens because our emotions get the best of us. Yes, emotions! Secular bull markets start at low, below-average P/Es. A combination of earnings growth and P/E expansion (which is a simple reversion towards the mean) bring spectacular returns to now jubilant investors.



Then the investors get overexcited about stocks and drive valuations (P/Es) to above-average levels.

P/E expansion is a powerful tailwind and a significant source of the returns during secular bull markets, but high P/Es can create a headwinds. When they start to fall, they curtail returns during secular range-bound markets. As P/Es stop expanding at the very late stages of a secular bull market, investors who were accustomed to above-average returns grow less than thrilled with lower rates of return. The higher the P/Es, the more difficult it is for stocks to continue to climb, as earnings growth alone cannot keep the secular bull market going. Returns from stocks decelerate to below the levels investors have learned to expect, and investors gradually migrate from stocks to other asset classes.

Welcome to a range-bound market!

Emotions now shift into reverse. P/E compression is like gravity pulling stocks down, where earnings growth is the force that counteracts its effects. All the benefits from earnings growth are gradually offset by constant P/E compression (the staple of range-bound markets). P/Es mean-revert from above to average to below-average levels. Stocks go nowhere for a long, long time in the process.

I discuss this topic in great detail with plenty of charts and tables on my [Contrarian Edge website](#).

### **US equity markets remain locked in a range-bound state**

In the US, economic performance has not been significantly different during range-bound and bull markets. That is, as long economic performance was not far from its average state we had either range-bound or bull markets. However, when you coupled high (above-average) valuations with long-term economic contraction, you had a secular bear market. This is exactly what took place during the Great Depression (and has taken place in Japan from the late 1980s until today).

In secular bear markets, economic growth does not offset a price/earnings (P/E) mean reversion; declining earnings add fuel to the fire and supersize the decline in P/E, thus causing stock prices to decline over a protracted period of time.

In the last (1982-2000) secular bull market P/Es reached their highest level ever. Today, nine years into a range-bound market, US stocks are still at above-average valuations. If over the next few years the US economy doesn't achieve positive nominal earnings growth, we may slide into a secular bear market.



The Fed is throwing an enormous amount of liquidity into the economy, yet it has very few tools to deal with deflation (you can make borrowing virtually costless, but borrowers may still choose not to borrow or to spend). The Fed is much better equipped to fight inflation: it can make money very expensive, and expensive money curbs spending. Thus, historically the Fed was willing to err on the side on inflation – be it in consumer prices, housing, commodities, or the stock market (“Bubbles-R-Us”). (In part we are paying today for the Fed’s handling of the 2001 recession: Alan Greenspan took interest rates to a very low level and kept them there for too long, starting a bubble in real estate.)

Current Fed actions may have the unintended consequence of promoting another bubble in stocks. I believe it will be harder to achieve a broad market bubble, since the more you stimulate the less effective stimulus becomes, over time; but I can see how a few sectors may (and already have) bubbled up.

The Fed and politicians will likely err on the side of overstimulating the economy, as the career risk for taking the economy back into recession through constrictive monetary policy is too great.

### **The exit strategy from a range-bound market**

Will my observations continue to play out in the future?

In my book *Active Value Investing: Making Money in Range-Bound Markets* (Wiley, 2007), I inadvertently created a framework that explains the mechanism behind stock market cycles. As things change over time one thing remains the same: our emotions will make us overexcited about stocks, and this will drive stocks to above-average levels, giving us cause to be underexcited (I think I just made up a new word), which will result in treacherous periods of range-bound markets.

If it were not for our emotions, stocks would always hew very close to their value levels (a normalized P/E of 15) and secular market cycles would not occur. I am oversimplifying; but if it were not for emotions, returns from stocks during short, intermediate, and long-term periods would be identical to their earnings growth.

Human emotions don’t let valuations (P/Es) remain in their average state of 15, and so they are driven to extremes, on both sides of the mean. Returns from stocks over short (one year) and intermediate terms (5, 10, or 15 years) may have a significant disconnect from their earnings growth. And the disconnect between earnings growth and stock market returns may persist for decades, or even longer.

Over, say, thirty years in the US (it takes that long for bull and range-bound markets to cancel out each other), returns from stocks will be in line with economic growth.



## **The role of technical analysis and market timing**

About a month after my book came out I regretted its subtitle, "Making money in range-bound markets.". People assumed that I knew what the range was, and the name also implied that I use technical analysis. "Sideways markets" would have been a more accurate description, but what's done is done.

Secular market cycles are full of many cyclical bull and bear markets; the last range-bound market, which started in 1966 and ended 1982, had five cyclical bull and five cyclical bear markets. It is impossible to succeed at short-term market timing, as you have to get two things right: the short-term economic numbers and the market's response to them, which in many cases may be irrational.

What I propose in the book (and practice at my firm) is active value investing. Instead of being a market timer, I'm a buy-and-sell investor, with a focus on valuing individual stocks.

## **Positioning against a decline in the dollar**

Though problems in the US are well-known, I am not a long-term dollar bear (though, as a hedge, we own some stocks that would benefit if the dollar continued to decline).

If the dollar is to fall, one must ask what against currency will it fall?:

*The Japanese yen?* Japan has its own, more immediate crisis: its economy has been in recession since the late 1980s, it has one of the oldest populations in the developed world, and its savings rate has declined greatly and is still falling. Japan has been trapped in a zero-interest policy that it may not be able to sustain for much longer. Its debt-to-gross domestic product is second only to Zimbabwe's, and even a small increase in interest rates will put a significant pressure on its budget. So the yen is not it.

As I have written previously, Japan was on the stimulus bandwagon for more than a decade; and with the exception of government debt-to-GDP tripling, Japan has nothing to show for it. Its economy is mired in the same rut it was in when the stimulus marathon started. It had a hard time giving up stimulus because the short-term consequences were too painful. Also, Japan is proof that a low (zero) interest-rate policy loses its stimulating ability over time and turns into a death trap for the economy as leverage ratios are geared to low interest rates. Now, even a small increase in interest rates (say, from 1% to 2%) would be devastating for Japan's economy."

The US is not Japan: our housing and stock market overvaluations were not as extreme; our corporations are in much better shape (though consumers are in worse shape); we are not xenophobic, thus our population is growing through immigration; we



don't have a significant cultural issue of "saving face" to overcome. Thus, although we sometimes don't let bankrupt companies go bankrupt to the degree we should – at least not since Lehman – creative destruction is allowed to exist to a far greater degree here than it was in Japan.

*The euro?* The euro blankets a collection of 20+ countries with very different interests. As John Mauldin put it, and I agree, the euro was created for prosperity, not adversity. Europe has its own demographic issues, such as high unemployment. So I am not betting on the euro against the dollar, either.

*The Chinese renminbi?* The People's Republic of China is neither the people's nor is it a republic. Despite its economic progress, China is still a communist country with a totalitarian regime and limited human and property rights. The Chinese government made the choice of growth at any cost even if projects don't (or barely) cover the return on capital. It has done so at the cost of undermining the purchasing power of its people by manipulating its currency, keeping it significantly undervalued. [I've written a lot about significant Chinese economic problems](#) will likely surface down the road.

Lately I've been hearing chatter of "nominating" the Chinese currency to reserve currency status. This is unlikely to happen for the reasons I've just mentioned, and also it goes against the Chinese business model. As long as the Chinese model is to be a low-cost producer and exporter to the world, reserve currency status is off the table. If the rest of the world decides to park their money in the Chinese currency, it will drive the renminbi up and decapitate China's export industry.

*Maybe the Russian ruble?* Unfortunately, Russia is a one-trick petrochemical pony. The natural resources of Russia are more a curse than a blessing, as they detract capital from and hinder development in non-commodity industries.

What's happening in the US isn't good for the dollar, but I'm not sure the rest of the world is in a much better position.

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