Ned Davis: The Cyclical Bull Rally is Not Over

By Robert Huebscher
November 17, 2009

In February of last year, Ned Davis, president and senior investment strategist of an eponymous Florida-based institutional research firm, correctly forecast last year's market decline. In February of this year, he called the market rally that began in March.

Now, he says, that cyclical bull rally is not over.

Davis, who is in his fifth decade as a market forecaster, spoke at last week's Financial Advisor Symposium in Orlando, Florida.

Synthesizing technical, fundamental and macroeconomic analysis, Davis identified seven indicators that correspond to secular market lows. Most of those are not in place, and he offered a neutral long-term forecast.

The cyclical bull market is not over

"I do not like to fight the tape," Davis said. His "Big Mo" indicator, which measures momentum across 100 industry segments, had reached an extremely bullish level of over 90 at the end of October, but it has since receded to 85, which Davis said is "moderately bullish." This level is consistent with a cyclical bull market, he said.

Another very bullish indicator, according to Davis, is the recent steep fall in corporate bond yields. Such declines typically coincide with rising equity prices.

Davis' reading of market sentiment, however, gives a slightly different signal. Noting that points of extreme investor pessimism typically coincide with the onset of market rallies, he showed that his sentiment indicator reached its lowest point (30.9) in March, a very bullish signal. That indicator now is 60.0 and signifies optimism, suggesting that investors should "take some money off the table."

Another bullish signal is that stocks do well when inflation is low. Davis presented data showing that stocks gained 18.1% when inflation was under 1%, 8.7% when inflation was 1% to 4%, 1.2% when inflation was 4% to 9%, and 0.7% when inflation was over 9%. His data reach back to 1947, and thus do not include the deflationary periods during the Depression, which many claim closely resemble today's environment.

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"A strong tape, corporate yields still falling, sentiment not showing extreme optimism, and low inflation are a pretty bullish signal," Davis said, adding that "at this point in time we don't have any evidence that the cyclical bull market is over."

Foundations of a secular market low

Secular trends, or super-cycles, encompass multiple cyclical market cycles, and Davis said they can last as long as 20 years. On a secular basis, Davis is neutral, based on his analysis of seven "foundations" of secular market lows.

The first of those seven is that money should be cheap and readily available, as it is today. Davis showed that secular bear markets consistently correspond to periods of negative growth in the real money supply; currently, the real money supply is growing by nearly 8% annually – a bullish signal.

Monetary growth has not translated to increased bank or consumer lending, which Davis said is necessary for this foundation to be solidly in place, and he concluded that this foundation "is not consistent with a secular low."

Neither is Davis' second foundation bullish. He requires that the debt structure should be deflated, but his data show that total public and private sector debt is at its highest level ever, and has been rising consistently since 1990, as shown below:

"This is the most negative chart that we have," he said.

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The ratio of the increase in debt to increase in GDP has risen in each decade since the 1950s, nearly doubling to 6.03 in the current decade from 3.12 in the 1990s. "We are just not getting the job done," he said, referring to the ability to grow GDP without incurring additional debt.

He also noted that, for the first time in history, combined federal, state and local government debt now exceeds GDP. "I am not certain we will solve the problem of too much debt with more debt," he said.

"There's not much pent-up demand for goods and service," he said, and that demand is Davis' third foundation for a secular low. Davis' data showed that demand had risen steadily since 1985 but fell off over the last year. It rose slightly during the last quarter, which he attributed incentive-based programs, such as "cash for clunkers" and the government's first-time home buyer program. "There's enough demand to keep the economy going for a while," he said, "but I don't see a sustained source of demand."

Over the short term, decreased savings correlate with rising equity prices, Davis said. Longer term, though, increased savings are necessary for a secular bull market. Savings are increasing now and are 3.3% of income, which he characterized as a neutral reading. "I don't think we have the savings we need for a long-term up-trend," Davis said.

The indicator that has the highest correlation to economic growth is non-residential fixed investment, Davis said, and currently investment there is weak. "Consumption really needs to drop and investment needs to pick up," he said.

Fundamentals are the core of Davis' fourth foundation, and he said the market valuations are neutral based on "time-tested, absolute valuation methods."

Davis looked at valuation three ways to demonstrate its neutral reading. His favorite is median P/E, which ranks all stocks based on their earnings yield and looks the mid-point. This minimizes the distortions created by differences in earnings reporting methods across companies, he said. Currently, the median P/E is 20.2 – compared to a median value over the last 40-plus years of 16.5 – and does not indicate undervaluation.

Davis said that Shiller's market P/E, based on 10-year normalized earnings, was "near fair value but not dirt cheap."

Based on dividend yield, though, the market is already overvalued, which Davis said was due to dividend cutbacks, particularly among financial stocks.

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The fifth foundation is that investors should be “deeply pessimistic” about the market and the economy. On that measure, Davis said advisor sentiment has turned positive and objectively generates a sell signal, but he believes that sentiment could get even more positive before the market turns down.

Consumer confidence about the economy has proven to be a good indicator for the market; extreme low confidence signals the start of bull markets, Davis said. Confidence was extremely low earlier this year and has risen lately, which is “good for the economy but still bullish” for the market.

Davis’ sixth indicator is that “major investor groups should have below-average stock holdings and large cash reserves.” Foreign investors have equity holdings well below their median value, but individual investor holdings and institutional holdings (excluding mutual funds) are just slightly below their historical median. “I don’t think institutions are really in shape to go on a big buying binge,” he said, and he rated this category neutral.

Davis referred to the “cash mountain” of excess money supply created by the Fed’s quantitative easing and said that much of this could end up going into the stock market. But, he added, he is “not as much of a bull as most people are” based on this indicator.

The final factor is “a fully oversold longer-term market condition in terms of normal trend growth and in terms of time.” Davis presented the following data:

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The blue line shows the total return, including dividends, for the Dow since the beginning of the last century. The red dashed line is the historical trend of 9.9% annual growth, and it shows where the market is in a secular cycle. It shows undervalued conditions in 1974 and 1982, and overvalued conditions at the peak of the tech bubble. The signal is currently neutral; the blue line is almost precisely at the trend line shown in red.

Emerging markets, gold, and advice for those in the market

Although Davis was neutral about the longer-term outlook, he does not see parallels to a Japan-like lost decade. He said two features differentiate Japan's plight from that of the US: Japan had a strong currency and negative money supply growth throughout its decline. "So far, we do not have those two factors," he said.

He believes the economy bottomed in June and is looking for a "pretty sharp rise off the bottom." But he said it's hard to make a strong case for growth without consumer spending and with continued job losses.

"Emerging markets are in a secular bull market, just the opposite of where we are," Davis said. While they are not yet in a bubble, he said, they could be soon. Although domestic equity funds are seeing outflows, Davis said foreign funds are seeing inflows. His optimism for emerging markets is based on favorable population demographics, and he said that if the dollar stabilizes and liquidity keeps up, "emerging markets are where you want to be."

"I am a big bull on gold," Davis said, which he believes is in a secular bull market. He does not believe the current gold rally is over, and as long as the Fed "trashes cash" by keeping interest rates low, he said, investors will move to gold. "That's the 5,000-year history." Like emerging markets, though, he cautioned that a bubble could soon form in the gold market.

Davis recommends hedging and option-writing to limit downside exposure for US equity investors. For those in the market, he recommends higher-quality stocks, particularly those with multinational exposure and ones with high dividend rates.

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