Walter Deemer's

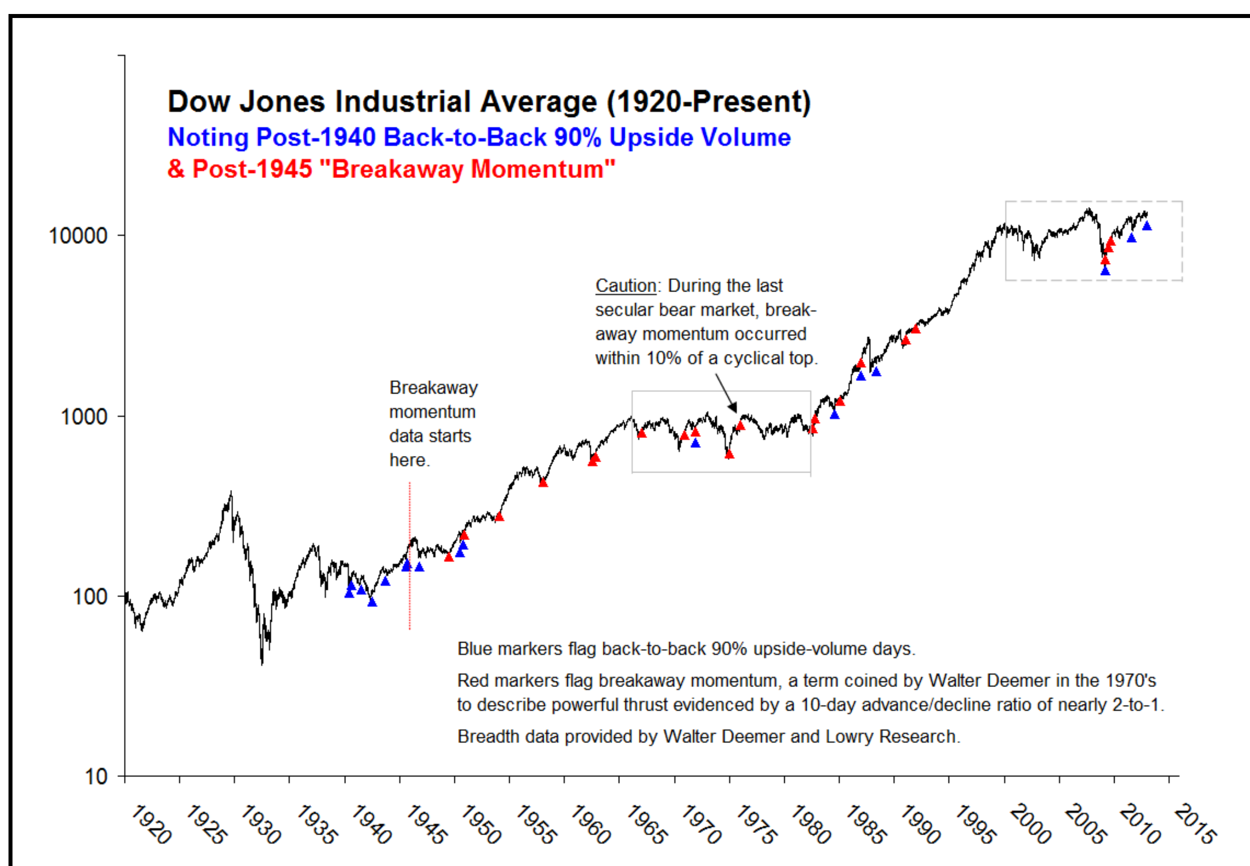
MARKET STRATEGIES AND INSIGHTS

...for Sophisticated Institutional Investors

January 27, 2013

PUTTING THINGS INTO A LONGER-TERM PERSPECTIVE

The stock market generated back-to-back 90% upside days at the turn of the year for only the eleventh time since World War II but then fell short of achieving breakaway momentum. This, I think, leaves us with a strong but not extraordinarily-strong rally on our hands – but let's look at where it leaves us from a long-term perspective.



The Secular Trend. A secular trend is one that persists over more than one conventional Four-Year Cycle. My old friend David Fuller, of FullerMoney.com, described it best when he called the process a "Secular Valuation Contraction".

The chart, from friend Mark Ungewitter, shows two previous secular valuation

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contractions – one from 1929 to 1949 and a second from 1968 to 1982. Note that the price low occurs during the first phase of the contraction (1932 and 1974) but the valuation low, when valuations reach generationally low levels, doesn't occur until its end. This means, of course, that the time from the price low to the valuation low sees prices going up -- but valuations going down even faster.

We have not seen that valuation low in the current secular valuation contraction yet. This means that if this current contraction follows in the path of the prior two the valuation low, with its accompanying public generational disinterest in equities, still lies somewhere ahead of us. That is the big long-term risk in the market here. With only two past precedents to go on, however, just how far in the future that valuation low lies is unknowable; the valuation low in 1949 came 17 years after the price low, but the valuation low in 1982 occurred only 8 years after the price low; the valuation low "window" this gives us, from 2017 to 2026, is not particularly useful. What history does suggest, though, is that the current secular valuation contraction has further -- perhaps much further – to run and that the current public disenchantment with stocks, as shown in things like the mutual fund money flows data, is likely to remain with us for quite some time to come. Note from the chart, for example (which, unfortunately, ends in 1995), that during the last secular valuation contraction in the 1970's and early 1980's there were net outflows from mutual funds throughout the period from the price low in 1974 to the valuation low in 1982; stocks got cheaper and cheaper during that time, but

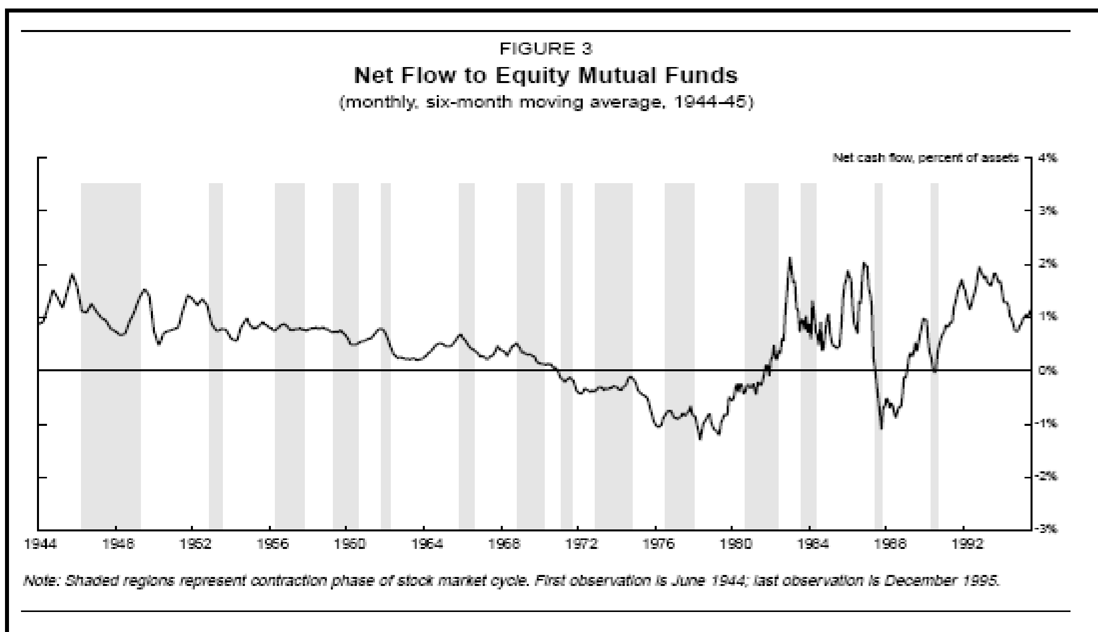


FIGURE 3
Net Flow to Equity Mutual Funds
(monthly, six-month moving average, 1944-45)

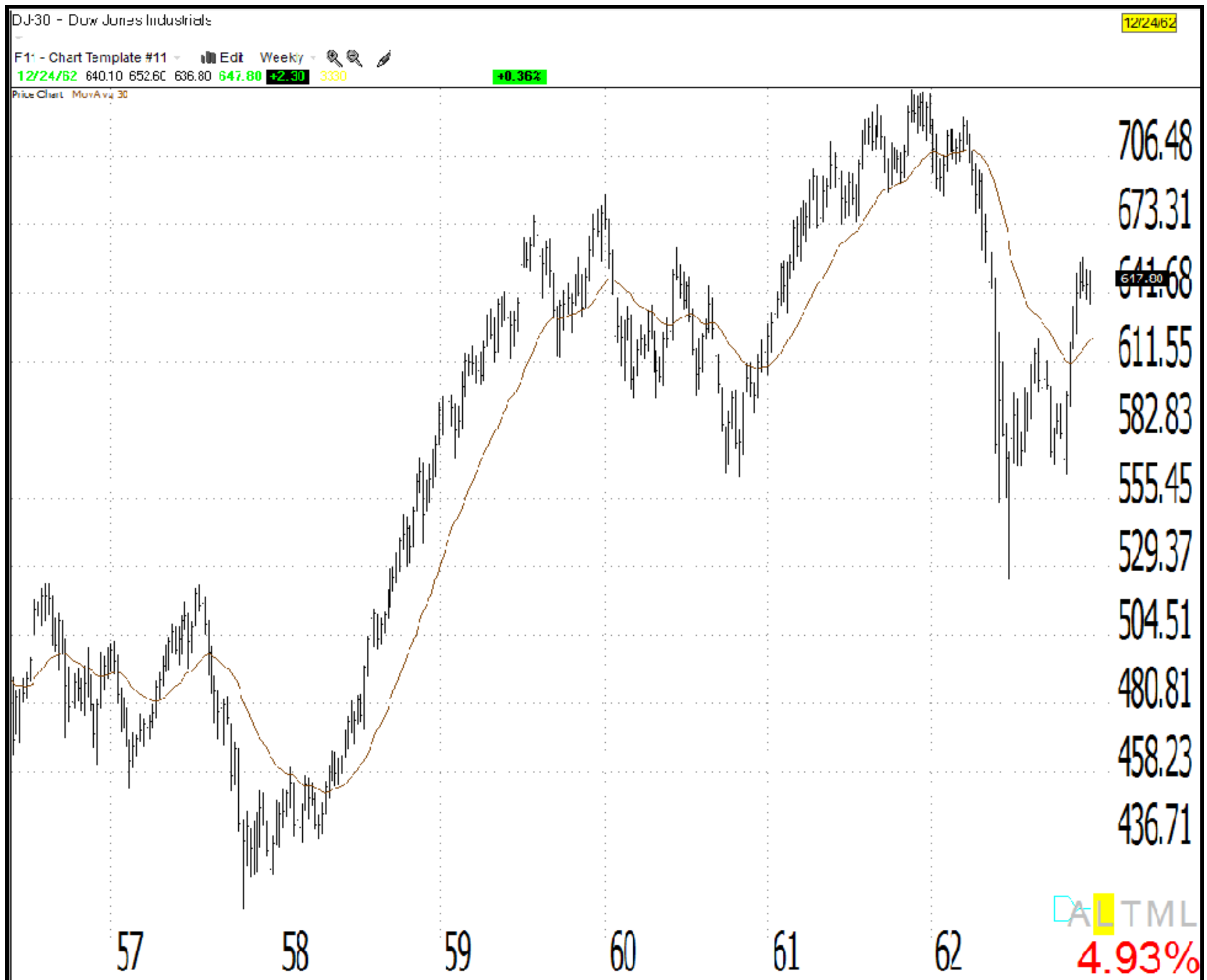
Note: Shaded regions represent contraction phase of stock market cycle. First observation is June 1944; last observation is December 1995.

the public simply didn't care. This means that if the valuation low still lies ahead of us – as history suggests it does – the recent inflows into mutual funds are unlikely to last very long.

The Four-Year Cycle. The bull and bear markets within the longer secular trend are called cyclical bull and bear markets, with the cyclical bull/bear process usually taking about four years to complete. The last Four-Year Cycle low was in March 2009, so the next one is therefore scheduled to occur in March-June of this year. It is quite obvious at this point, however, that the stock market is not going to make a Four-Year Cycle low by March-June. This means that the stock market is in another Four-Year Cycle Extension like the ones it staged in 1961, 1987 and 2007.

We'll take a look at those three previous Bull Market Extensions on the next three pages.

CHART 1: Dow-Jones Industrial Average (Weekly), 1957-1962

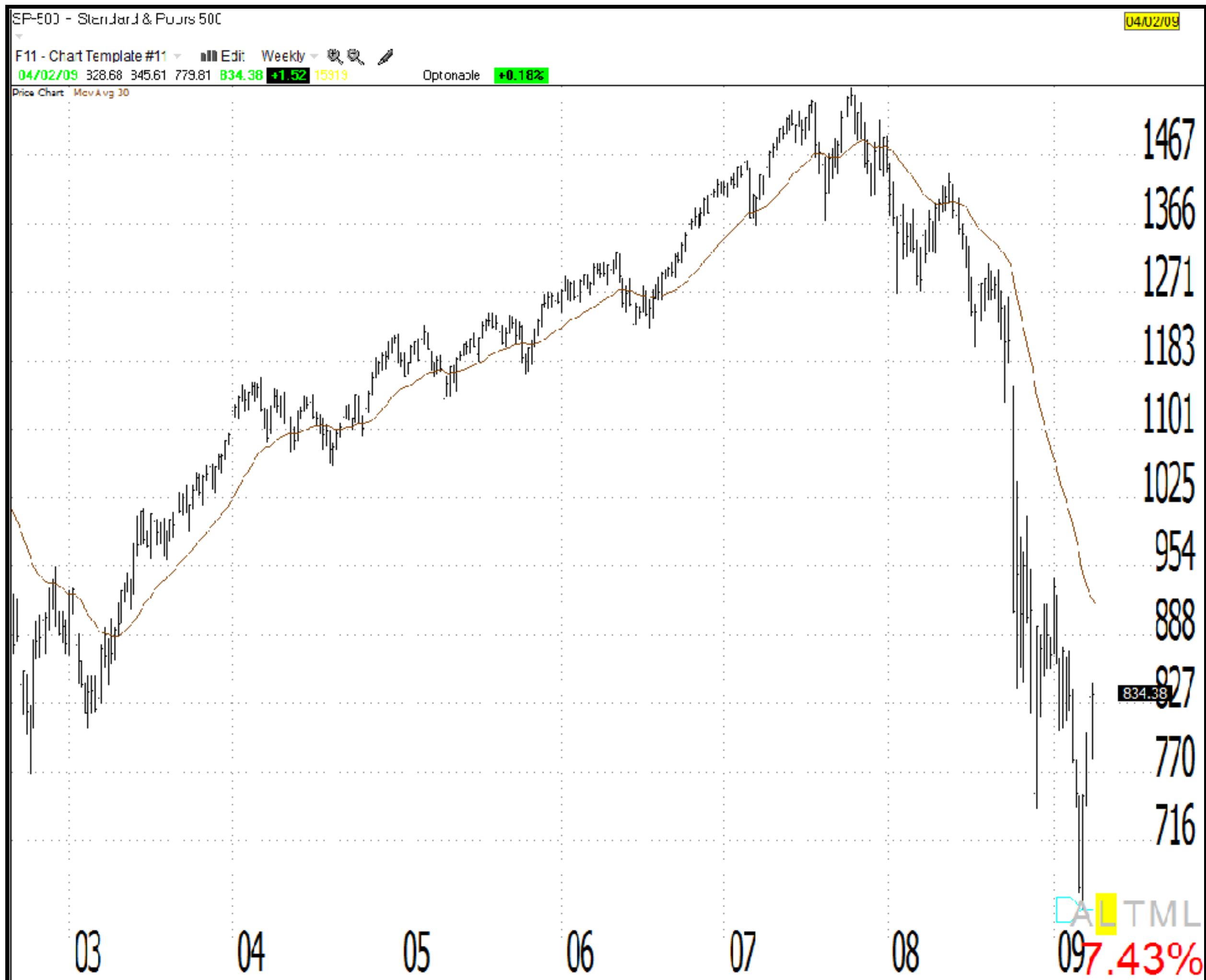


Bull Market Extension I was in 1961. The stock market made a rather emotional major low in October 1957 (the "Sputnik low", when Russia unexpectedly launched an earth satellite before we did and thereby cast grave doubts on our nation's scientific leadership). This meant that the next Four-Year Cycle low was due in late 1961, but the market staged a very speculative rally in early 1961 led by bowling, vending and electronics stocks, and the blue chips were able to keep going until December of that year. As a result, the Dow-Jones Industrials made a top in late 1961 rather than the scheduled bottom. Afterwards, it plummeted 29.3% to its June 1962 low in what became known as The Crash Of 1962.

CHART 2: Dow-Jones Industrial Average (Weekly), 1982-1988

Bull Market Extension II was in 1987. The stock market made a major low in August 1982, so the next Four-Year Cycle low was due in the third quarter of 1986. The market, however, staged a high-level consolidation during the second and third quarters of 1986, then embarked on an ever-giddier advance to the Dow's August 1987 high of 2746. Less than two months later, though, it traded at 1616 – a 41% plunge known forever after as the Crash Of 1987.

CHART 3: S&P 500 (Weekly), 2003-2009



Finally, there was Bull Market Extension III in 2006 and 2007. The Four-Year Cycle low had been made in October 2002, so the next one was due in late 2006. The market, however, completely ignored this and peaked a full year later, in October of 2007. It then staged the most severe decline since the Great Depression – 58% -- which led to the Four-Year Cycle low in March of 2009.

The Four-Year Cycle, it must be remembered in all this, is a behavioral cycle, not an economic one; the bull and bear markets that occur within it serve to correct (and usually overcorrect) the excesses of the preceding bull or bear market. With those behavioral roots in mind, the fact that the bear markets which followed the three Bull Market Extensions were – without exception – more severe than average: 29%, 41% and 58% can, I think, be attributed to the fact that the extensions gave the excesses of the

preceding bull market more time to build up – which meant that there were more excesses that required correcting by the subsequent bear market. Whatever the case, I don't think the fact that all three Bull Market Extensions were followed by more-severe-than-usual bear markets can be dismissed as a statistical fluke.

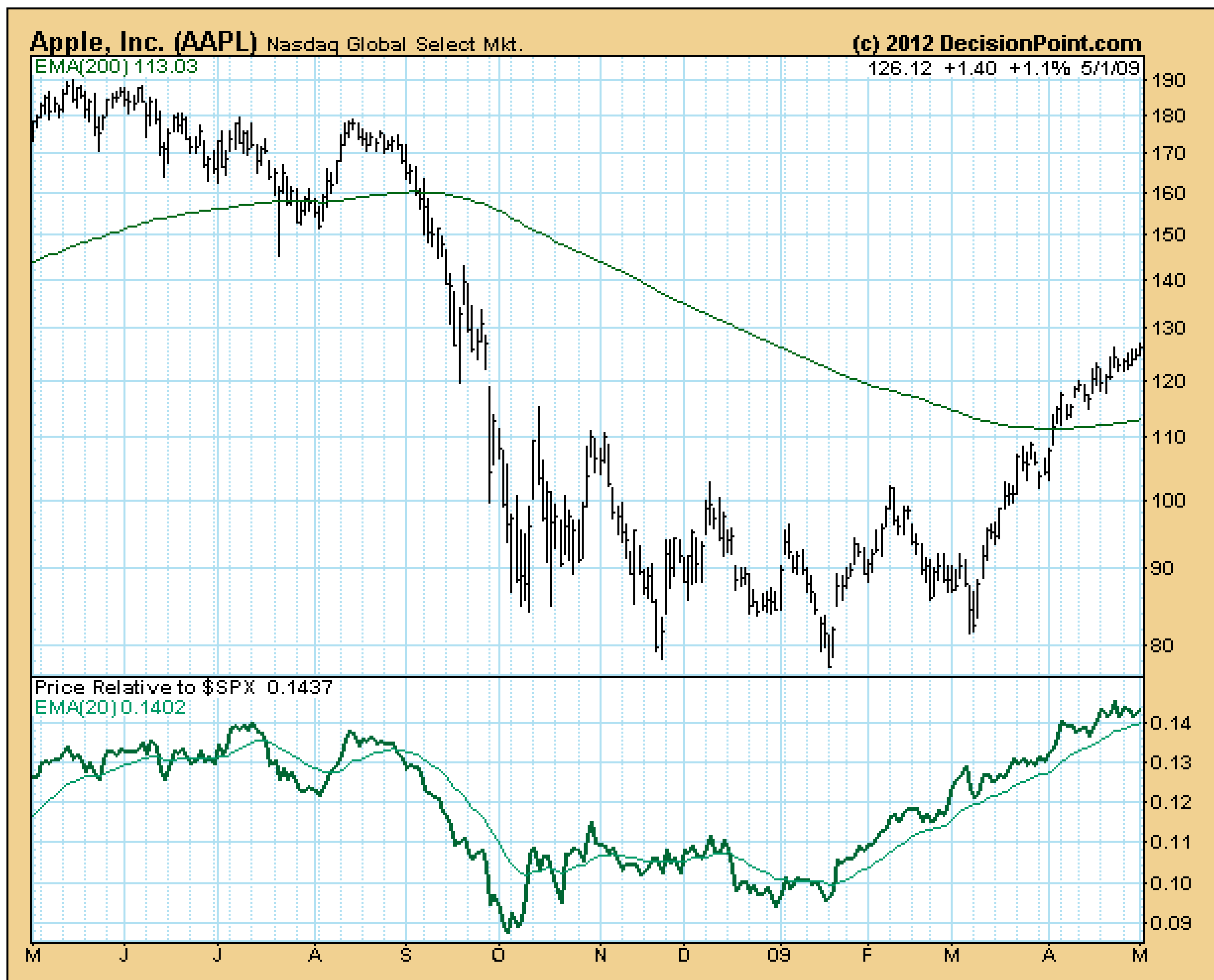
How long could the current Bull Market Extension last? The one in 1961 peaked at about the time the next Four-Year Cycle low was scheduled to occur. The ones in 1987 and 2007, though, saw the market continue higher for a full year following the scheduled Four-Year Cycle low. Based on this and this alone, the market could – could – continue to go up until the first half of 2014, although there is also a one-in-three probability that it will peak in March-June of this year. I wouldn't place a great deal of confidence in that first-half-of-2014 possibility with just three past precedents to go on, though, so let's leave it at this: The current Bull Market Extension could peak anywhere between a month or so from now until sometime in mid-2014.

The bottom line: Bull Market Extensions are tricky affairs that may or may not extend well beyond the scheduled Four-Year Cycle low. The only firm conclusion we can draw is that since all three Bull Market Extensions were followed by well-above average bear markets, the decline following this Bull Market Extension is also likely to be an abnormally-big one.

The Market Now. Although the market failed to generate breakaway momentum in its early-January attempt, the back-to-back 90% upside days on December 31 and January 2 and the market's subsequent unwillingness to stage a "normal" correction indicates that the underlying trend is pretty powerful here. It will take a while for this underlying strength to dissipate, so – for the moment at least – my very real longer-term concerns have been overridden by the shorter-term strength. Despite this shorter-term strength, however, longer-term risks are still above-average here.

Leadership. Our Fidelity sector fund relative strength work has done a good job in identifying leadership; our switching program holdings, for example, are Construction & Housing, Consumer Finance and Multimedia, and the top three funds this week are Brokers/Investment Managers, Automotive and Construction & Housing.

Reasonably-high yielding dividend growers, meanwhile, come and go as market leaders as risk appetites ebb and flow, but they nevertheless represent a core area of solid long-term leadership that is likely to hold up relatively well during any periods of unpleasantness in the market. (I should add, though, that I have more than once observed that "relative strength in a bear market sucks!") Technology, meanwhile, continues to be the weakest of the S&P sectors – and it's not just Apple. Finally, some – but not all – emerging markets are leading the global markets; the strongest emerging markets include China, India and Mexico. The Japanese stock market has also just staged an impressively-powerful advance, but it should be noted that the Nikkei is a lot stronger in yen terms than in dollar terms.



Apple. This chart shows the decline and bottoming process of Apple in 2008 together with a relative strength line comparing AAPL to the S&P. The stock went

down very fast in September 2008, rallied 35% in four days(!), then traced out a bottoming pattern during the next five months that featured several undercuts of the October price low that didn't follow through on the downside accompanied by a clear upturn in the relative strength line in mid-January.

History won't repeat, but if it rhymes at all Apple, when it finally stops going down, is likely to spend a fair amount of time building a reversal pattern before it will be in position to start back up again (assuming, that is, that it isn't another Cisco *a la* 2000). That 35% rally in October 2008 and the several other 25%-plus rallies in late 2008 and early 2009 were clearly tempting, but the real long-term buying opportunity in AAPL back then wasn't until the relative strength line made that big positive divergence in early March.

-- Walter Deemer

FIDELITY SECTOR FUND	PRICES in cents) Jan 23	Jan 16	Jan 9	Ja2 '13	R/C	DTR STRENGTH RATINGS Jan 23	Jan 16	Jan 9	Ja2 '13	Dec 26
Broker/Invest	5419	5317	5244	5138	12	181	169	169	133	95
Automotive	4004	4025	3997	4006	-11	174	186	187	170	140
Constr/Hous'g	5218	5039	5005	4992	30	172	141	150	130	97
Chemicals	12583	12409	12379	12232	7	160	153	155	129	106
Airlines	4339	4308	4247	4133	-8	154	162	149	109	92
Multimedia	6110	5968	5910	5905	14	152	138	139	125	76
Environmental	1797	1761	1762	1748	14	146	132	135	112	86
Energy Serv	7256	7017	6899	6857	45	145	100	85	50	25
Transport'n	5598	5504	5406	5283	-1	142	143	118	74	51
Financial	6553	6446	6389	6305	12	138	126	125	94	60
Comm Equip	2450	2437	2363	2397	-6	135	141	115	133	114
Materials	7507	7375	7390	7333	14	126	112	125	104	82
IT Services	2704	2637	2634	2622	15	116	101	113	88	65
Insurance	5477	5368	5317	5297	16	115	99	107	92	47
Indust Equip	3890	3794	3790	3785	15	114	99	101	84	62
Industrials	2692	2657	2627	2588	8	113	105	95	71	43
Consumer Finance	1526	1535	1530	1504	-21	110	130	142	105	63
Defense/Aero	9081	8907	8970	8918	7	107	100	113	94	67
Energy	5371	5279	5192	5188	20	106	85	74	49	33
Wireless	861	847	843	848	7	104	97	108	105	74
Natural Gas	3277	3197	3171	3158	28	98	69	73	46	18
** Emerging Mkts	4447	4443	4444	4522	-10	96	106	114	124	88
Electronics	4829	4809	4695	4742	-12	94	106	70	65	15
Biotech	11705	11724	11839	11393	-13	92	105	136	106	48
Nat Resource	3383	3330	3284	3292	19	92	73	65	42	28
Medical Equip	3005	2927	2923	2845	18	88	71	81	47	20
Leisure	10551	10458	10510	10406	9	83	74	92	60	48
Banking	2023	2017	2003	1987	-8	83	91	86	60	23
Healthcare	14122	13989	14042	13719	0	82	83	105	76	42
Pharmaceutical	1584	1573	1572	1530	-4	81	85	96	61	32
Software	8616	8525	8460	8466	1	79	78	82	65	27
Computers	6552	6401	6246	6308	18	77	60	43	41	-1
Consumer Discr	2692	2649	2619	2607	7	77	70	69	52	20
* * S&P 500	149478	147263	146102	146242	6	72	66	67	56	24
Telecommun	5195	5083	5168	5202	14	67	53	80	83	48
Retailing	6544	6445	6315	6318	5	67	62	59	52	17
Consumer Stpls	8338	8241	8108	8164	-4	59	63	59	64	31
Utilities	5902	5777	5746	5768	10	57	47	52	42	0
Medical Del	5976	5892	5828	5837	10	51	41	49	34	0
Technology	10436	10329	10322	10410	-3	49	52	56	53	10
* * T Bills	1985	1985	1985	1985	0	0	0	0	0	0
Gold	3619	3656	3577	3771	-5	-78	-73	-80	-41	-55