

# BARRON'S Online

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## Bear's Pause

The rally is just a phase of a long-term down market, researcher says.

By SANDRA WARD

**AN INTERVIEW WITH NED DAVIS** -- Armed with rich databases of economic and market information, along with any number of proprietary indicators, Davis and his team at Ned Davis Research in Venice, Fla., are able to pinpoint trends and patterns that are scarily reliable in assessing where the market is headed. The penetrating analysis and prescient prognostications are the reasons that Ned Davis Research, founded in 1980, counts 851 paid-up subscribers in 32 countries and has 4,962 people on its mailing list. He graciously took our call recently and offered his thoughts on why this rally is for real, and why the continuing bear market is also.

**Barron's:** *I hear you've become more positive about the market.*

**Davis:** Well, I feel much the way I did when we had the interview last year. *This is a cyclical bull market within a secular bear market.* There have been some distinct improvements since we last spoke, but basically the message is the same.

**Q:** *What's improved?*

**A:** *Since October of last year, corporate bonds have been up nearly every day.* They've been really strong, and that is an added stimulus on top of what the Fed has been doing. *The tax cuts* certainly have had more of an investment tinge this time around. *Not only did we get a dividend cut and the capital-gains cut, but people in the top bracket will see their rate cut from 38.6% to 35%.* That's a tremendous drop in taxes. So that's a tax cut on top of a tax cut that was already out there. The dollar, which had been drifting down for almost two years now, really started tumbling earlier this year, and that's another stimulus. It is a risky stimulus, but another one all the same. There have been so many added kicks that the market took off after mid-March.

**Q:** *But how stimulative are these tax cuts? Don't they just benefit the rich?*

**A:** *There is some truth to that. But the rich are the ones that own the stocks.* So, it won't mean much for the whole economy or for the 1.8 million people who have lost jobs in the past three years, *but it is very bullish for the stock market and stock investors.*

**Q:** *What's been the impact of long rates coming down?*

**A:** *Long rates were providing huge competition for stocks.* Also, *a lot of companies had gotten themselves into very heavy debt and were not able to tap the commercial-paper markets and had to raise money in the corporate bond markets at higher rates, which was a drag on earnings.* There were a lot of bankruptcies and to help them service the debt, long-term rates needed to come down. *The yield on Baa, the main corporate investment grade, has dropped 21% in the past year. That's about as low as they've ever dropped.* *This was a tremendous stimulus. We find a 1% drop on a 12-month basis tends to be bullish for the market.*

**Q:** *What else points to a cyclical bull?*



Wayne Eastep

Ned Davis says "cyclical bulls" like the current market can last for a year. He's been buying tech stocks.

**A:** We went back and classified the market as secular periods of three to four cycles of 16 to 20 years and then broke those down into secular bull periods and secular bear periods. Very, very long supercycles. We studied cyclical bulls within secular bear markets and found that they didn't last as long as other cyclical bulls and they didn't go quite as high, but in the 17 we looked at, the S&P 500 went up an average of 50.6% and lasted 371 days on average.

**Q:** *More than a year?*

**A:** Some of these were in the 1966 and 1982 period when the market went up for two years, but we are using averages here. Still, they were quite substantial. Then, while there are a lot of dissimilarities between Japan and the U.S., I think there are a lot of similarities, too. We looked at the secular bear that started in 1989 in Japan and found four rallies of 48%, 34%, 56%, 62% that also lasted many, many months. That gives you an average of 50%. And it confirmed what we found in cyclical bulls during secular bears here. On top of this cycle, the U.S. also has a presidential-election cycle and from the mid-term election year lows, which are usually reached in the fall, to the high of the next year, we've typically had rallies measuring 51.2% on average. Those are three different measures that suggest we could have a pretty substantial cyclical bull, even amid this long-term bear market.

**Q:** *How much of this have we already experienced? The market is up quite a bit.*

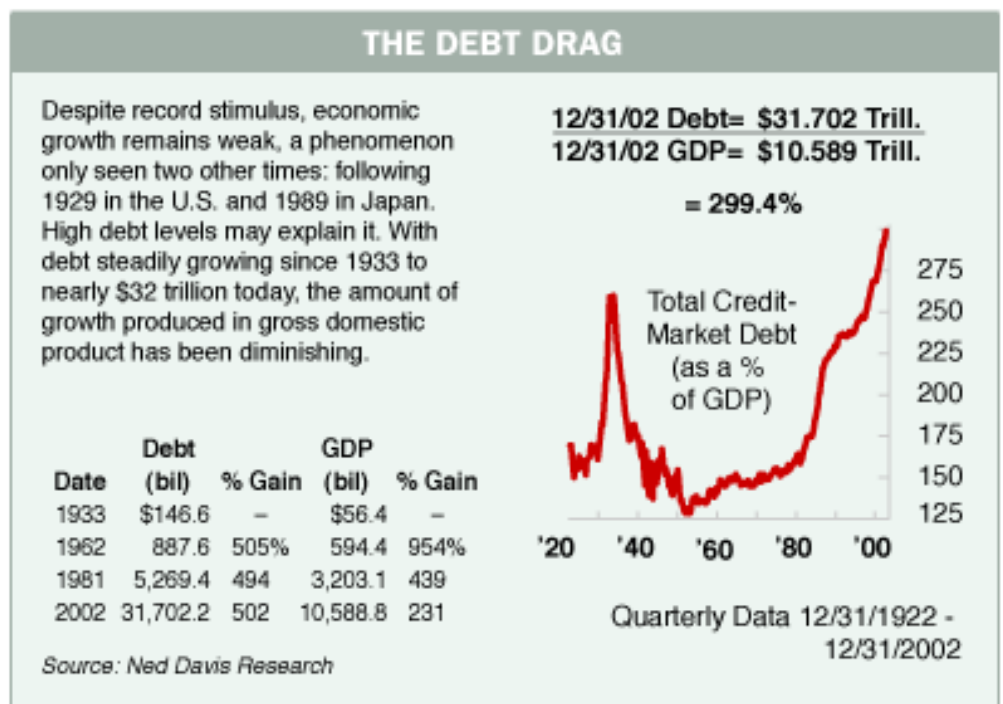
**A:** The S&P is up about 28% from the lows. The NDX 100 [Nasdaq 100] is up 53% from its low and has already gained as much as the S&P usually does in a cyclical rally. But we looked at all the rallies in this secular bear since the 2000 high and we also looked at the rallies in Japan, and we found, in almost every case, speculative growth stocks tend to lead these rallies. We saw this after the 9/11 lows. The S&P went up 21% and the NDX went up 53%. For whatever reason, whether it's the level of short interest or beta or the nature of bear-market rallies, the leadership is very speculative, so even if the S&P goes up by 50% or so, the Nasdaq could double. Already, biotechs and Internet stocks have doubled. If the S&P goes up by another 100 points or whatever, surely they would participate, but maybe not to the extent that they have so far.

**Q:** *What's your model asset allocation?*

**A:** We are 65% stocks, which is 10% overweight the benchmark, 30% bonds and 5% cash, both of which are 5% underweight the benchmark. I wouldn't call that a negative position on bonds, but clearly we are favoring stocks right here.

**Q:** *Where are you putting your money?*

**A:** Last year, our work pointed us toward large-cap growth stocks. In the past month or two, we shifted to small-cap growth. We are still very heavy in the financials. But they are slowly coming off our list, and tech and growth stocks are picking up. There is a general feeling that the financials are overdone, and overweighted in the S&P. I'm not convinced yet. They still act pretty good. In every cycle where there is excess, the banks finance it, so they typically end up getting in trouble. In this case, they all have been financing mortgages and housing prices have risen. Actually, the mortgage foreclosure rate is at a record high, but it is still only 1.1%. That is not the kind of thing where you really get into trouble. I thought the REITs would be the first place we'd see problems, with the downturn in commercial real estate and the fact that their dividends weren't going to be favored in this tax law. They did have a pretty big correction, but they are back up at their highs right now. It seems as if they should be getting hurt here.



**Q:** *Any other areas that you're positive on or more concerned about?*

**A:** All across the energy spectrum -- in particular natural gas -- we are seeing demand higher than we would have expected and supply a lot weaker than we expected. We really see a lot of problems in the supply-demand situation for energy, and the selloff that occurred after the war was a buying opportunity.

**Q:** *What about the hiding places for the bear market you liked last year?*

**A:** I thought you could hide in bonds and utility stocks. The utilities didn't do too well for a while, but they have certainly come on like gangbusters lately and that could be because of the dividend tax cut. I still like that group. Bonds have done well, too. A lot of people have been saying for a couple of years now that bonds were overvalued. But only since the end of May has our bond valuation index shown them to be overvalued. Bonds -- corporate and government -- are not a good hiding place right now. My guess is they are going to have a pretty big correction in the third quarter, and that may end up being a good time to buy them again.

**Q:** *Why the correction?*

**A:** They've had a tremendous run here. My suspicion is that the economy is really going to surprise people in the third quarter and if that comes about, after people have grown accustomed to sluggish and muddling growth, we could see a very strong third quarter and, if so, the bonds would sell off. The pickup in the economy won't be sustainable and therefore bonds would be a good buy if they have a good shakeout. But I wouldn't own them now.

**Q:** *Why won't the pickup in the economy be sustainable?*

**A:** All the stimulus will make a difference. But the first round of stimulus only lasted a quarter, and I am worried that may happen again. Unemployment is still a weak spot. If we do get a booming quarter as I expect, there's the risk that rates might go up. Or the dollar will continue to collapse. In either case, the boom won't last.

**Q:** *And the boom is driven by consumers continuing to spend?*

**A:** They've been selectively doing that. Mostly in autos and certainly in housing. Mortgage refis and mortgage applications have been at new all-time highs. That's the Fed's position, really: make cash trash. People don't know what to do about it. A year or so ago, there were some things to do because bond yields were high and housing was booming. Now the bond yields have gone away. Short-term rates are certainly going to go away. They may cut them another half-percentage point. After fees and all, you are getting zero on money-market funds. So where does that money go? Auto sales really have stalled out, but the incentives are dramatic. When people get the reduction in their withholding and a check in the mail, that may be just enough to kick auto sales up again. Housing is still booming.

**Q:** *What's your take on the housing market?*

**A:** There are pockets of bubble. But it's not like the stock-market bubble. It's not even close. If there's another run here, and we put another whole layer of housing boom on top of the mountain we have, that might be very risky. I do think there is a mortgage-debt bubble now. People say it's not a problem because rates are low and housing prices are going up. That is all true. But still the debt has got to be paid. If housing stalls or interest rates go up, the mortgage-debt bubble becomes a really big problem.

**That is the Catch-22 the economy is in. We've got this \$32 trillion debt bubble out there, and it is as risky as can be. And, yet, rates are plunging, so everything looks manageable. It is true we've had 2.4 million bankruptcies filed since the economy started up in the fourth quarter of 2001. But, with rates down at these levels, we are managing. If somehow the Fed succeeds this time and things heat up again, interest rates will start up. The debt service will be enormous and that will put us right back to where we are now. That is the problem. If the Fed doesn't pull this off, and they don't trash cash and they don't force people to go out and spend their last dollar, or borrow their last dollar, then you are looking at deflation. And that is terrible.**

**Q:** *Somehow then, they have to manage in this little sweet spot for quite a while.*

**A:** Right. If they heat things up, it is bad and if they don't heat things up, it is worse. They have clearly chosen to try to heat things up. You've got an election next year and they have a good shot at it. My guess is we'll have a great quarter, maybe a little longer than a quarter, then rates go up and it will end almost immediately.

There is not a lot of pent-up demand. All the pent-up demand is coming from driving rates lower and lower and lower.

The other side of that, the other big secular risk I see -- and it all ties together -- is that our exports are exactly what they were back in 1997. This either means our goods are not competitive or the dollar is way overvalued. It is probably a little bit of both. We had a productivity jump, though I am not convinced it is as good as the numbers show. Given that productivity jump, our goods should be competitive, and they are not. We definitely needed to see the dollar come down, but it needs to come down carefully and slowly. If foreigners understood our policy is what I think it is, that is, making cash trash, why would they keep their \$3 trillion in this country? At the point they realize this, this nice decline in the dollar all of a sudden becomes tremendously bad.

**Q:** *So how do you respond to a cyclical bull market within a secular bear market? Are you bearish or bullish?*

**A:** As a trader, I'm long and I'm bullish. We might get another 10%, maybe more. The question becomes how do you know when the falling dollar turns from a positive to a negative? It becomes negative when it starts impacting the bond market. Given the dollar situation, given the \$32 trillion in debt, I don't think the bond market needs to go up anymore. But it needs to behave. It can't start tanking. What will end this rally is either the tape deteriorating or the bond market starting to really go down.

**Q:** *And you're trading in and out of small-cap growth stocks?*

**A:** Yes, mostly tech and biotech stocks. Every week since we became pro-Nasdaq we read -- often in Barron's -- that tech is back in a bubble. It is unnerving, it seems like there is a tech stock every day that has a problem, including IBM recently. It is very hard to sit here but that's where the leadership is.

**Q:** *But you still think this is a "Humpty-Dumpty" economy.*

**A:** It is not going to feel that way next quarter. I will be very surprised if we don't have a big jump in activity. But when you have this kind of debt -- we've had two rounds of tax cuts and 12 cuts in interest rates and only one good quarter of economic activity -- that tells me there is a tremendous drag, whatever they want to say about debt being manageable and debt service being low. There is another drag in that the stock market's valuation, if you look at actual earnings, clearly is not cheap. You can get a cyclical bull but you can't push it too far because the turnaround stocks are already overvalued. If you go buy that we are in a secular bear, this is not just a little animated correction.

When you look at past secular market bottoms, the P/E on stocks was 10 and the dividend yield was 5%. You can talk about stocks at 15 times earnings being good value, but if you go back to 1942, 1949, 1974, 1980, 1982 and 10 P/Es and 5% dividend yields, we are not even close to that. It becomes clear that with all the talk about the debt bubble, it still isn't being discounted by the stock market.

**Q:** *A lot of people don't seem to think it's a problem.*

**A:** The Fed is trying to keep the economy afloat while we are working ourselves out of debt. The problem with what they've done to get the economy going is they've tried to cure the problem of too much debt by adding more debt. It all looks good as long as rates stay down here. I think whatever the Fed is doing is wrong, but I don't really know what else they can do. If our problem is we save too little and borrow too much, what are we doing now? We are making savings worth zero and we are telling people to borrow. We are doing just the opposite of what we need to do. The reason they are doing it because they are scared to death of deflation. They are scared to death of a depression. So they are fighting it tooth and nail, and I think short-term it is going to look pretty good. But I am very dubious about the long term.

**Q:** *What are mutual-fund flows telling you?*

**A:** It is minor really, but we're seeing inflows again to funds after months of outflows. They are not big but they are decent. It started in March and April. What was interesting was that fund managers didn't spend the money or spent very little of it. It showed a fair amount of pessimism. It is not like they've got much cash to speak of. If you want to make a bullish case based on fund flows, you have to base it on the fact that for the past three years, a lot of institutions have been putting a whole lot more money in bonds rather than stocks. So portfolios may be out of line with too much exposure to bonds. They don't have a lot of cash, so in order to rebalance and buy stocks, they are going to have to sell bonds. The question is: When they start to sell bonds, will that send interest rates up or is the inflation picture so positive that it won't hurt bonds?