

## Longer-Term View: Secular Bear Market and Status of “Long Hard Slog”

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### 2011 Outlook

**GDP GROWTH:**  
3.2%

**UNEMPLOYMENT:**  
9.4%

**INFLATION:**  
1.75%

**FED FUNDS RATE:**  
0.35%

Bull or bear market? On a long-term, secular basis, we are of the opinion that the U.S. has been experiencing a primary, secular “bear” stock market environment since the year 2000. Primary bear markets are vicious animals which consume wealth over a long period of time. Wealth is destroyed in various forms (real estate, financial assets, business values) both on an absolute and “real,” after inflation basis. It has long been our view that the current bear market started in the year 2000. While we have seen temporary respites in the financial destruction of this secular downturn in asset values, the underlying, grinding trend of lower real asset values driven by a strong world-wide fundamental is still in existence.

We have been emphasizing the increased volatility of the markets – and attaching that increase to the real reason behind the current bear market – an unsustainable debt level in many western countries. Until this debt problem is forcefully and successfully addressed, we have been forecasting that high levels of market volatility will continue – creating financial “Black Swans” which are far out of the norm of expectation. **We sense we may be entering the final phase of the “Long Hard Slog” environment – one of final capitulation – where the excesses which are the culprit of our problems will be dealt with.**

### Stages of the Bear

Secular Bear markets are rare. We have only experienced three other secular Bear markets since the year 1900. They are long, drawn-out affairs during which wealth destruction takes place on a massive scale. They occur due to secular, seemingly unsolvable problems, or worries. Bear markets occur over many stages, but the final stage is highlighted as a period of capitulation – where everyone agrees on the main problem (this time it is debt structure) and finally the market or officials show investors a way out of the maze. We do not believe the world has been shown a way out of this maze, but given historical standard, we believe that is the next stage of this bear experience – one of capitulation and finalization. Is this going to happen during 2011? Perhaps. We have already experienced the first two stages of this Bear market:

- Onslaught. We have a problem. Not everyone is in agreement of what the problem is – it is not apparent. Perhaps the symptoms of the systemic problem change, but the problem remains the same. People come to the conclusion that we have a problem that is probably systemic.
- Agreement. Agreement is eventually reached, due to events which unfold over a long period of time that highlights the real problem. The solution seems completely out of reach and unsustainable. However, agreement of the problems rather than simply the symptoms of the problem, are reached.
- Capitulation, Solution and Finalization. This stage can be chilling, but for many investors, it is a period of determination and solution. **We believe this is where we as a people stand, and where the world’s investors currently are positioned. A proposed solution will occur – the solution to the problem may be a process in itself – but we have passed the phase of shock and the phase of agreement of the nature of the issue.** The capitulation and finalization period may take some time – perhaps a period of a few years, perhaps not. At any rate, this based on historical precedent, **marks the end of the bear market and the beginning of the bull.**

## History Lesson

First, from a definitional standpoint, our view of a primary bear market is a long period of time where stock prices, after inflation have contracted. In other words, it is a period of time when real capital was destroyed by owning stocks. To put the current bear market in perspective, since early 2000, the real (after inflation) value of the U.S. stock market has declined by roughly \$23.6 trillion. U.S. GDP is \$14.5 trillion. So, from a “real wealth” standpoint, almost 1.5 years of total economic production has been erased of the last 11 years due to the current bear market. This is serious wealth destruction.

Our country has experienced four such periods of time since the year 1900. During the last 110 years, by this definition, the U.S. stock market has been in a primary bear phase for 54 of the 110 years, and a primary bull market for the remaining 56 years. Following is a table (provided by our friends at Ned Davis Research) which highlights both primary bull and bear markets since the year 1900.

Bear Market Dates	“Real” (after inflation) Stock Price Change	
	<u>Per Year</u>	
1/1906 – 8/1921	-5.4%	
9/1929 – 4/1942	-10.1%	
2/1966 – 8/1982	-7.9%	
1/2000 – 12/2010	-2.6%	
<b>Average Duration of Bear Market:</b>	14.8 Years	
<b>Current Duration of Bear Market:</b>	11.0 Years	

Each of these secular bear markets have been driven by systemic economic issues – issues which at the time seemed insurmountable. Following are the drivers behind these secular bear markets.

**1906 – 1921:** During this extended period of time, WWI obviously occurred, but a real driver behind the long-term secular bear market is associated with the business cycle concept of boom/bust. During this 15-year period, there occurred five economic contractions (the word recession was not yet in use), totaling 46 percent of the time. In other words, the economy was in contraction as much as it was expanding. A then-famous economist, Joseph Schumpeter made popular the view that manias and economic contractions were normal, common events, leading towards his popular thought of “creative destruction.” It was not until the 1920’s the view started to prevail that economic expansions could last longer than a year or so. This marked the end of the boom/bust market and economic scenario of the early 1900’s and led to the Roaring ‘20’s. The new bull market ran from 1921 to 1929, during which the Dow Jones average rose by 639 percent.

**1929 – 1942:** Perhaps the grand-daddy of all secular bears, this bear started with the 1929 crash, and did not end until WWII was well underway. Economic collapse led stock prices downward, driven by many issues, including distorted and ill-advised tax policies, trade-limiting tariff decisions, interest rate hikes leading to a period of protracted monetary tightening and the demonization of Wall Street speculators. Germany had gone through a period of terrible inflation, being driven by tenants of the Treaty of Versailles with war reparation payments to the Allied powers. These payments were an attempt to cripple Germany's capability to wage war in the future, and simply led to the installation of fascist powers in Germany during the 1930's. Socialist oriented governmental systems gained traction during this period, leading to capitalism coming under attack. World War II broke out. In 1942, within weeks of the end of the bear market, the U.S. naval victory at Midway occurred, along with successful bombing raids on Germany. These events showed investors that indeed, the capitalistic system was going to be saved not only from the Great Depression, but also the threat of centralist powers taking over the world's economic system. The bull market of 1942 to 1966 was the longest on recent record, during which the Dow Jones average rose by 998 percent.

**1966 – 1982:** During this sixteen year period, inflation roared. Following a period of price stability, governmental policies combined with oil embargos led to a period of rapidly rising inflation. The world was convinced that inflation was here to stay, and oil, gold, real estate and other prices were only going to rise by 10-plus percent per year. What a person could have purchased in 1966 for \$100 cost \$298.05 in 1982, due specifically to inflation. Investor's savings were endangered due to rising inflationary impact. A wage/price spiral had taken over the mentality of many in the country. It was not until the appointment of Paul Volker to Chair the Federal Reserve, and subsequent interest rate hikes, that our nation's investors became convinced that yes, indeed, inflation was coming under control. Inflation continued to be higher than desired in 1982 (6.2 percent) but it was apparent the issue was coming under control. The following bull market, from 1982 to 2000, is fresh in many investors' memories. During that period, the Dow Jones average rose by 1,536 percent, representing the greatest bull market of recent history.

What do the above examples of past secular bear markets have in common? First, they end. Secondly, they last between 12 and 15 years. **They end prior to the final solution to the problem which the world is facing and fully in place. For each and every secular bear market to end, the world needs to witness the way out of the problem. The actual problem does not need to be solved. Lastly, when they end and the new bull market occurs, real wealth creation occurs, and historically by massive amounts.**

## Why is the Bear Growing?

So, what is the secular problem the world is currently facing? Two issues, which combined, have led to the economic contraction we faced a couple of years ago, and still have not been resolved. These two forces are:

- A change in the growth profile of the world's economic powers. During the last 15 years, the world's economic growth leadership has shifted from countries which border the Atlantic Ocean to those which border the Pacific Ocean. This is a broad generalization, and consequently is not exactly accurate, but the theme is realistic.
- A massive increase has occurred in the utilization of debt by the countries which are losing growth share on a world-wide basis. Major western countries have borrowed capital from many non-western investors to finance living standards which are beyond the capacity of their own economies to support.

The combination of these two factors (decreased growth and share of the world's income statement combined with an explosion of debt creation) has led to a destabilized economic environment – one with which the world's investors are attempting to become comfortable. Until rationalization – both economic and political – of this major, macro change takes place, the world's equity markets will probably remain in a secular bear environment.

We have been writing about this development for the past 3 years, as it is the core case as to why the U.S. economy is growing slowly – we have consumed our way to a point where debt structure is unsustainable, and we (along with major portions of the rest of the western world) will need to live within our means going forward. This by definition has led to lower secular growth rates, combined with investor and banking system uncertainty on a world-wide scale.

Bear markets end when the major reason behind the bear market is forcefully and successfully addressed. As mentioned, the negative issue(s) of why the bear market exists does not necessarily need to be solved, but a **solution needs to be understood and in sight. The solution and ramifications of the solution to the problem which the world is faced has not yet been forthcoming, and consequently is not yet understood. Until this solution occurs (and it may be applied to one or a few of the troubled spots worldwide), the markets should remain in a secular downtrend. And economic uncertainty, driven by a reallocation of worldwide growth combined with insatiable appetites for leverage, will continue to create global economic and banking imbalances.**

## The Roadmap to Solvency

Where is the world located in this road back to some degree of normalcy? Of course, assuming one believes the global financial and banking systems are stuck in the bear market described above, this is the meaningful question. How much further – both as measured by time and magnitude – do the world’s financial markets need to move prior to a final bottoming process taking place? No one knows the answer to this question. But suffice it to say, we believe we are some period away from this finalization of the secular problems becoming more evident.

However, it makes sense for us to understand how deep and pervasive a problem with which we are faced. Once again, we believe the problem the world markets are facing has to do with a severe shift in the world’s income statement. The world’s economy and growth of the world’s economies have changed dramatically during the last 15 years. At the same time, the world’s balance sheet structure has changed dramatically. Debt creation has occurred in many of the countries in which share of income statement has been declining. The combination of reduced income and higher debt is deadly – for any economic unit, be it a family, a business or a country.

At this stage of the analysis chain, we need to make some assumptions. First, the share of world-wide GDP broken down by geographic segments is as follows:

### World Nominal GDP

As of 12/31/08

	<u>12/31/08</u>	<u>12/31/98</u>	<u>Change</u>
U.S.	24.8%	30.1%	-5.3%
Other Industrialized	43.9%	48.3%	-4.4%
<b>Total Industrialized Nations</b>	<b>68.7%</b>	<b>78.4%</b>	<b>-9.7%</b>
<b>Emerging Economies</b>	<b>31.3%</b>	<b>21.6%</b>	<b>+9.7%</b>

Now, who are the countries losing share of the world's income statement? Let's look at the large players in this mix and look at the sovereign balance sheets of each of these countries:

**National Debt Structure**  
**Measured by Government Debt**  
 To GDP (as of 9/30/10)

	<u>9/30/10</u>	<u>1998</u>	<u>Change</u>
U.S.	92%	66%	+26%
Japan	180%	71%	+109%
U.K.	65%	42%	+23%
<b>Average</b>	<b>112%</b>	<b>60%</b>	<b>+52%</b>

Three of the largest industrialized nations are mentioned above. These three nations' currently represent more than 35 percent of the world's output. On average, the governments of these three economic leaders have almost doubled their use of debt as a percent of the size of their economies during the last 12 years! Recently, the hole in which the nations mentioned above is just getting deeper. The current budget deficit of a number of countries is listed below, as a percent of GDP:

**Federal Budget Balance**  
 As % of GDP – Last 12 Months

<u>Country</u>	<u>Budget Balance</u>
U.S.	-9.0%
U.K.	-13.5%
Japan	-7.4%
France	-7.8%
Italy	-5.0%
Germany	-3.7%
<b>Average "Old World" Countries</b>	<b>-7.7%</b>

Compare some of the developed countries to some of the countries which have seen a surge to the upside in percentage of world-wide GDP:

<u>Country</u>	<u>Budget Balance</u>
China	-2.2%
Canada	-3.7%
Poland	-2.7%
Russia	-4.0%
Australia	-3.1%
Hong Kong	+2.9%
India	-5.5%
S. Korea	-1.9%
Thailand	-0.2%
Argentina	-0.3%
Brazil	-3.0%
Israel	-3.9%
<b>Average "New World" Countries</b>	<b>-2.3%</b>

It is evident what is happening. As the developed world loses share of world-wide GDP to the developing world, governmental consumption appetites do not shrink. Governments simply borrow more money – until the bond market participants worry about debt structure and repayment and say “enough.” This in effect, is what happened to the banking system and sovereign debt systems in a number of countries during 2010.

**Expect more of the same in 2011. Particularly if central government powers simply throw liquidity at solvency problems. Temporary band-aids do not work when deep surgery is the order of the day!**

Countries can take care of debt problems in a number of ways. We have highlighted many of them in the past, from currency sacrificing to policies which spur strong economic growth. We do not believe the developed world has the stomach, demographics or financial flexibility to grow our way out of this mess. With this in mind, we expect the value of the U.S. dollar to decline and inflation expectations/realization to accelerate during the next few years.

## The End Game

So what does all this mean? Since late 2007, we have been writing that debt creation and debt servicing, along with lack of income growth, will lead to a period we designated as the **“Long, Hard Slog.” That slog continues, and will not be dealt with easily. Slower-than-normal GDP growth coupled with higher-than-normal unemployment trends are hallmarks of this period. On a world-wide scale, we believe the equity markets are going to be in a bear cycle until this issue is addressed, and forcefully, at many governmental levels.**

We expect to see a period of serious political give-and-take occur in Washington and in the capitals of Europe. Many believe, and rightfully so, that this period of problem solving will not occur until we see another financial calamity unwind. Consequently, during the next few years, we have come to the opinion that the equity bear market, which started in the year 2000, is still with us – just currently in hibernation. We believe an event – an “ah-ha” moment – may occur within the next year or so which will arouse the bear from his slumber. This event more than likely will be caused by debt and leverage structure.

**Now, perhaps this does not need to occur.** Two studies of particular note have occurred which address this significant issue. One, the study completed by the National Commission on Fiscal Responsibility and Reform entitled “The Moment of Truth,” includes some very useful and great ideas. The other study, “Getting Back in the Black” done in collaboration by the Peter G. Peterson Foundation and the PEW Charitable Trusts, is worth noting. Both of these studies address our growing dependence on foreign-financed debt structure and the unsustainability of this financial scheme. **At the least, the release and general acceptance of these reports that something needs to be done (taxes increased, spending decreased) is a sign that we have entered a new phase of the secular problem – that is, a phase of reconciliation and solution.**

**We suggest when the majority of our nation’s investors understand and support these types of austerity measures, the “ah-ha” moment may come to pass and the new, multi-year bull market may start for not only U.S. equities, but also stock markets around the world. In the meantime, it appears to us that the 11-year old bear market may at least celebrate its 12<sup>th</sup> birthday prior to final hibernation.**

## Final Word

Lastly, we would like to change the tone of our piece, to include something fun – “10 Surprises” – both good and bad – which have a chance of occurring in the year 2011. I asked our staff for ideas. A number of ideas came back. Some were reasonable, some not. However, please find below some thoughts which need mentioning – all in headline form.

## 10 Surprise Headlines for 2011

1. Dow Jones Average Sets New High as Debt Problems Solved!
2. Inflation Fears Surge: 10-Year Treasury Yields Surge to Above Five Percent, Stocks Weaken.
3. Oil Price Spikes to \$130 Per Bbl as Demand is Stronger Than Anticipated.
4. Fed Raises Rates as GDP Growth Accelerates Rapidly!
5. The Euro Collapses as German Citizens Refuse to Back Foreign Debts.
6. In Surprise Move, China Annexes North Korea, Warding Off Armed Conflict.
7. After 90 Years of Independence, Irish Prime Minister Returns Keys of the Country to U.K!
8. Governor Brown Solves California Debt Problem.
9. Illinois Credit in Default. Federal Government Steps in to Guarantee Pensions.
10. Hillary Clinton Resigns as Secretary of State – Now What?

We hope this longer-term piece brings some clarity to the investment world in which we currently live. This is a confusing, difficult period with which to deal – be it in finance or business in general. We as a people are facing a seismic shift in how the world functions – economic growth changes and balance sheet realignment processes are difficult, be it for a family, a business or a country. We as a people need to come to grips as to what our governmental structure is supposed to be about – what do we expect from our government? This question is in the process of being answered. In the meantime, the bear market of the 2000-2010 era continues. We are looking forward to an end of this bear and the beginning of a new, sustainable bull market.

At the least, the “Long Hard Slog” is now measurably well underway.



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