Wells Capital Management

Economic and Market Perspective

March 21, 2016 Bringing you national and global economic trends for more than 30 years

A bull, a bear, or a bunny?

James W. Paulsen, Ph.D
Chief Investment Strategist,
Wells Capital Management, Inc.

Most investors wonder if the recent rally in stocks marks a resumption of the bull market or whether it simply represents another temporary respite from an unfolding bear market. However, perhaps the rest of this economic recovery will be characterized not by a bull nor by a bear, but rather by a bunny! Unlike an enthusiastic bull or a scary bear, a bunny market hops about a bit but really does not go anywhere and bunnies have often dominated the stock market during the latter stages of past economic recoveries.

The accompanying exhibit illustrates the U.S. stock market since WWII with recessions shown by the grey bars. In the last two expansions (during the 1990s and again in the 2000s), the stock market was uninterrupted by a bear market posting solid and steady returns until the economic recovery ended with a recession. So far, despite some volatility in 2011, this has also characterized the contemporary bull market. Without a bunny market in more than 20 years (as shown in Exhibit 1, the last bunny market was in the mid-1990s), most investors currently seem to accept that either the bull market will soon resume or we are nearing the end of this expansion. Since there has not been one in some time, few consider that stocks could simply be headed for another bunny market.

Post-war bunny markets

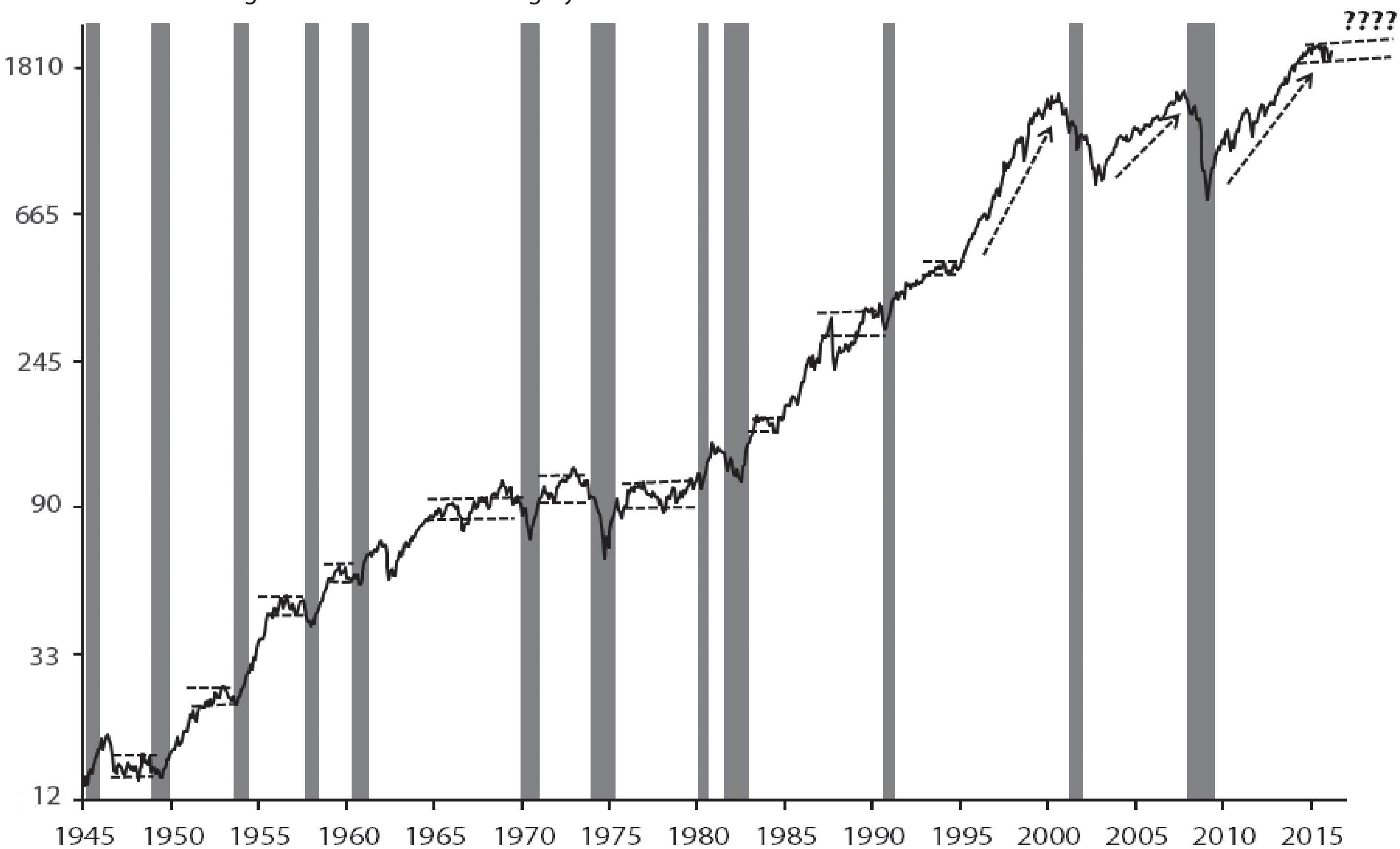
The Exhibit highlights several periods in the post-war era when although the economy remained in an ongoing expansion, the U.S. stock market trended essentially sideways. Sometimes the bunny hopped about fairly radically (e.g., during the last half of the 1960s or the latter-half of the 1980s), whereas other times the bunny was lethargic and stock prices remained in a narrow range (e.g., the late-1940s, mid-1950s and mid-1990s). In all cases, though, the stock market remained essentially flat (or made only marginal gains) over an extended time despite an ongoing economic recovery.

Most bunny markets occur in the latter part of an economic recovery. Stocks initially recover aggressively after a recession. However, as the recovery matures, cost-push pressures, inflation, and higher interest rates begin to pressure the bull market. This often resolves into a bunny market for the balance of many economic recoveries. Examples highlighted in the Exhibit include the late-1940s, between mid-1951 to mid-1953, 1956 to 1957, 1959 to 1960, the last half of the 1960s, most of both of the 1970's recoveries (inflation and cost-push pressures were almost immediately evident in the 1970's recoveries), and finally 1987 to 1990. Bunny markets have also occurred as investors initially adjust to the Federal Reserve starting to tighten monetary policy. For example, this happened between mid-1983 to mid-1985 and again between 1993 and 1994.

Exhibit 1

S&P 500 Composite Stock Price Index

Shown on a natural log scale with recessions in grey.



As illustrated, there can be significant advances or declines during bunny markets (indeed, bear markets as classically defined by a 20% decline have been part of past bunny markets). Whether the bunny hops about considerably or is rather calm, what distinguishes a bunny market is it's essentially a flat trend. Buy-and-hold (bull market) or sell-and-avoid (bear market) strategies are not successful during bunny markets. Rather, the market becomes a trading opportunity where timing becomes paramount. For those not good with timing, investment options shift to good stock picking, decisions regarding sector weightings, better possibilities for alternative or hedged investment strategies, and/or consideration given to higher allocations toward other asset classes which may still be trending (e.g., bonds, commodities, currencies, or international stocks).

Perhaps most importantly, the bunny market is a "tweener" market. Evidence of a bunny market does not necessarily suggest investors should start getting defensive in preparation for the next bear market. Nor should it persuade investors toward risk-on approaches in anticipation of a resuming bull market. As illustrated in the Exhibit, the bunny market can persist for years "between" the bull and the bear.

While future returns from stocks during a bunny market are likely to be far less than earlier in the bull market, they often remain reasonably positive for an extended period. A bunny market is neither bullish nor bearish. Rather, it simply requires the consideration of different investment strategies compared to those employed earlier in the bull market or used later as a bear market approaches.

Are we in a bunny market now?

For several reasons, we believe U.S. stocks recently entered a bunny market. First and most importantly, we think U.S. recession risk remains low and if the economic recovery is not ending anytime soon, a sustaining bear market is unlikely. U.S. economic policies are not recessionary. The Treasury yield curve remains strongly positively-sloped, yields are low and have recently declined, the money supply continues to grow at a steady and strong pace, and fiscal stimulus as a percent of GDP remains positive. None of the traditional economic policies currently signal elevated recession risk.

There are also few current excesses evident in the economy. The energy industry was the only major sector characterized by a boom but it has already recently been refreshed.

There has not been excessive consumer spending (indeed household savings rates have risen in this recovery), and household debt service ratios are near record lows while net worth is at a record high. Capital spending has certainly not been overdone and the factory utilization rate remains below 80%. The housing industry has not boomed. Businesses are not overstaffed. There simply are not the excesses that normally precede a recession.

Moreover, balance sheets remain remarkably strong throughout the economy. The household debt-to-GDP ratio has declined by almost 20% in this recovery, the ratio of U.S. corporate debt to corporate profits is no higher today than it was in the early-1970s and the banking industry has perhaps never been better capitalized at any point in U.S. history.

Finally, confidence among private economic players is simply not strong enough to worry much about an imminent recession. Recessions often result when economic players (consumers, investors, businesses, and policy officials) become overconfident in the future and engage in behaviors that ultimately need to be liquidated by the next recession. There is no evidence of this type of attitude today. There is not excessive lending or borrowing, companies are not overstaffing or overbuilding, consumers are not overbuying, investors are not overexposed to stocks, and the Fed is certainly not over-tightening. It may take higher levels of confidence and broader animal spirit behaviors before the next recession is near.

If the U.S. economy is still a ways from the next recession, a sustainable bear market is a low probability.

Second, in our view, an enduring solid bull market is also unlikely. The stock market faces several vulnerabilities during the rest of this recovery. The U.S. corporate earnings cycle is mature. Profit margins are near record highs and labor cost as a percent of sales is near record lows. Should sales growth remain weak, since profit margins are not likely to be raised further, earnings growth should be far slower during the balance of this recovery. Conversely, should sales growth improve, profit margins will likely compress offsetting much of the improved sales performance. The stock market also is no longer cheap. The trailing price-earnings (P/E) multiple on the S&P 500 Index is currently about 18.5. With core inflation rates and wage inflation recently accelerating, the stock market will not be bolstered by valuation enhancements during the rest of this recovery. The combination of high current valuations, a modest earnings growth outlook, and increased probability of rising interest rates should keep the bull subdued.

Lastly, the contemporary period exhibits both of the characteristics that have historically resulted in bunny markets. That is, today, investors are struggling with both the start of the Federal Reserve's tightening cycle and with an economic recovery moving toward its latter innings. Every bunny market highlighted in the accompanying Exhibit was facing at least one of these two hindrances and today the stock market is facing both simultaneously.

How to play the bunny?

How should investors react to a bunny market?

We continue to expect another flat U.S. stock market this year. For the S&P 500, our year-end target remains 2050 with a range of about 1800 to 2200. During the balance of this recovery, we expect earnings growth to about equal the pace of nominal GDP growth. Consequently, investors should anticipate about 4% to 5% earnings growth, and with no assumed improvement in valuation, expect about 6% to 7% annualized returns during the balance of this recovery. And, knowing the bunny, returns will not likely be a straight line but rather a bit hoppy.

In a bunny market, investor strategies can no longer simply be bullish or bearish. Several additional approaches should receive consideration.

First, some marginal market timing may be beneficial. Adding to overall equity exposure after periods of significant weakness and trimming exposure after solid runs (i.e., trying to profit from bunny hops) could help augment returns. However, since the bunny is trendless, major asset allocation shifts or simple buy-and-hold decisions are no longer appropriate

Second, the potential value-added from stock picking may be much greater today and during the balance of this recovery than it has until now. While the bunny may significantly reduce overall equity asset class decisions (i.e., big winning bets by just being significantly overweight or underweight stocks), it will not likely reduce the potential opportunities from individual selections.

Third, similar to individual stock selections, sector allocations will also remain important. Specifically, we expect leadership to be led by industrials, materials, and capital goods sectors rather than consumer-based sectors. We also believe the late-cycle character of this recovery of cost-push pressures, higher inflation, and rising interest rates will favor small and mid cap stocks and value over growth sectors.

Fourth, investors may want to consider increasing exposure towards international stocks. Both the international developed and emerging market recovery cycles are at a much younger stage compared to the U.S. recovery. Moreover, since they have underperformed for the last several years, they represent better relative values and are under-owned. Finally, because their recovery cycles are not as mature as the U.S. cycle, their stock markets may remain more bullish as opposed to "bunnyish."

Fifth, bunny returns are likely to be less than the bull returns stock investors have enjoyed so far, suggesting that other asset classes should be considered? The prospective returns from either cash or bonds, however, are not attractive. Cash still offers essentially a zero yield which is only advantageous if a bear market is imminent and bonds are likely to suffer a significant challenge during the balance of this recovery as yields finally sustain an advance. Conversely, commodities and other real assets may be worth a look. We believe commodity prices are finally bottoming and real assets overall should do well relative to financial assets in the balance of this recovery as full employment pressures continue to aggravate inflation anxieties.

Finally, hedge strategies struggled during the bull cycle of this recovery since most were unable to keep up with rapidly and persistently rising public equity markets. However, in a bunny market, investors may be able to enhance the portfolio risk and return profile by allocating some to hedge approaches.

The Easter Bunny is coming this weekend and perhaps he may continue hopping about for the rest of this economic recovery!

Thanks for taking a Look!!

Written by James W. Paulsen, Ph.D.
An investment management industry professional since 1983, Jim is nationally recognized for his views on the economy and frequently appears on several CNBC and Bloomberg Television programs, including regular appearances as a guest host on CNBC. *BusinessWeek* named him Top Economic Forecaster, and *BondWeek* twice named him Interest Rate Forecaster of the Year. For more than 30 years, Jim has published his own commentary assessing economic and market trends through his newsletter, *Economic and Market Perspective*, which was named one of "101 Things Every Investor Should Know" by *Money* magazine.