

## The Coming Decade of Sideways Markets

By Robert Huebscher

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*I spoke to Vitaliy on December 29.*



**Your latest book, *The Little Book of Sideways Markets*, was just published. What is a sideways market?**

Let's begin with some definitions so we can speak clearly about this. When I talk about markets, I'm talking about secular markets that last longer than five years, usually decades or longer.

When we think about secular markets or markets in general, we tend to think of them in binary terms: "bull" markets are going up, "bear" markets are going down. But over the last 100 years markets spent half the time in bull and half the time in a "sideways" phase. Secular bear markets happened a lot less often than we think. The only *secular* bear market we had was the Great Depression.

Think about sideways markets this way: The economy has a lot of small (cyclical) bull and bear markets, but when we are in a sideways market in the long run it just stagnates. This is similar to what S&P 500 did over the last 10 years – we had two bear and two bull markets, and yet the market is still not far from where it was in 2000.

To understand why this happens, you have to understand the simple arithmetic of why stock prices go up in the long run. They are really driven by two factors: earnings growth and change in price-to-earnings ratio. If price-to-earnings ratios had not changed over last 100 years and stayed at 15 (their long-term average), you would have had no market cycles, and markets would have gone up in tandem with earnings growth. Earnings in the long run would have grown in line with GDP, or about 5 or 6% a year, so stocks would have gone up gradually over time as the economy expanded.





But investors get overexcited about stocks, and they take price-to-earnings ratios from below-average to above-average levels. That is when you have secular bull markets. And then investors take price-to-earnings from above-average levels to below-average levels, which is when you have sideways markets. This happened consistently over the last hundred-plus years.

In sideways markets, earnings growth is offset by price-to-earnings decline, and markets go nowhere.

In bull markets, you have earnings growth and you have price-to-earnings expansion. That is why the returns are so good. This is a very important point: Over last hundred years or so, economic growth was not that much different during sideways and bull markets.

### **What stage is the US market in now?**

We are in the middle of a sideways market, and we still have another decade to go.

How do I know this? The principle is that P/Es go from above average to average to below average, and they stay at the below-average level for some time. If you look at the last sideways market, which was from 1966-1982, price-to-earnings did not just go from above average and briefly touched below average level before we had a bull market. No. Price-to-earnings spent half of the time at below-average ratios before the next bull market (1982-2000) started.

Though the stock market briefly visited below-average P/E levels during the Great Recession, that dip was not likely the end of the current sideways market.

### **With regard to price-earnings ratios, are you using normalized P/E ratios?**

Yes. This is a very important question, because the "E" in one-year P/E ratios is heavily affected by the cyclical nature of the economy. Profit margins play a very significant role in what one year (trailing or forward) earnings are at any given moment of time.

Profit margins today are very high, and they rarely stay above their average for long. Therefore, if you look at stocks based on forward earnings, they don't look that expensive, but those earnings anticipate continuation of very high margins that are not sustainable.

P/E computed on ten-year trailing earnings more accurately describes how cheap or expensive the market is, as earnings averaged over ten periods capture the complete economic cycle (high and low margins). Historically, the average P/E ratio



based on 10-year earnings was about 18, slightly higher than the 12-month trailing P/E. Today the normalized P/E is close to 25 times earnings.

Stocks in general are still not cheap.

### **Can the difference between 18 and 25 be justified by the fact that interest rates are so low?**

I talked about this in my book. This is a very important point. It is not just enough to say interest rates are low and therefore P/E ratios should be high. You must understand where interest rates are – in one of three zones: inflation, normal, and deflation.

Today's interest rates are very low not because the economy is great, but because it isn't. The Federal Reserve is afraid of deflation. Deflation is not good for stocks, because it would be accompanied by slow economic growth, and you would have higher corporate bankruptcies and defaults. This means higher risk. The Federal Reserve is trying to move rates lower, not just on the short-term side of the curve but also on the long-term side, because they are afraid we are going to have another recession.

It is not necessarily good for stocks if interest rates are low because you are afraid of deflation. You want interest rates to move from the deflation zone to the normal zone. If long-term rates go up to 5 or 6% and short-term rates go up to 3 or 4%, that would be good for stocks, because it would mean the economy has stabilized. That is not what is happening today.

Of course, having *very* high interest rates is not good for stocks either. But the point is that just because interest rates are low, that does not necessarily mean that you should have high valuations. Today interest rates are low for a very important reason that is not conducive to higher price-to-earnings.

One last point on this: Japan had very low interest rates for 20 years, and their price-earnings ratios did not expand; they contracted.

### **Are there signals that will indicate that we are moving out of this long-term secular sideways market into a bull market stage, other than interest rates moving up?**

A good clue would be the media basically throwing in the towel on equities and saying that nobody wants to own equities ever again. I'm so glad that *Business Week* did not go bankrupt, for many reasons. I don't want those reporters to lose their jobs, but another reason is that I am looking for them to be the contrarian indicator – to write an article on the "death of equities" like they did in the early



1980s. That would be another sign that we are out of the sideways market. I don't see those signs yet.

Right now, sentiment is very, very bullish, and people basically expect the bull market to continue. So the sideways market is marching on.

**We did have a fairly substantial move by individual investors into bond funds for most of this year.**

That's right, and now they are trying to get back into stocks. Part of the rally we had was because individual investors are afraid to miss the boat. If you look at the AAIL [American Association of Individual Investors] sentiment, it is at a multi-year high.

**Within your clients' accounts now, how much cash are you holding? As a value-oriented investor, what downtrodden and neglected asset classes do you consider attractively priced?**

In the fourth quarter of 2010, our cash balances peaked at 35% as we were selling stocks that became fully valued. Our cash balances have declined since to 28%, however, because even though the market was going up, some stocks declined and became good bargains.

You find value today in an unexpected place. When I look at the economy today, I'm not necessarily sure that this recovery is sustainable, or the speed of the recovery is sustainable. Therefore, we have positioned the portfolio very conservatively for a very slow recovery. The stocks you want to own in that environment are high-quality stocks.

Ironically, these are the stocks that are cheap today. Usually you pay premium prices to hold high-quality stocks. Today, they are priced at a discount. We see a lot of value in high-quality, stable stocks in the health care area, priced at seven- to eight-times earnings, with strong balance sheets and high dividends. They also have strong pricing power in case we have inflation, and they'll be able to maintain prices if deflation pays us a visit.

**Let's talk a bit about China, because you have written a lot about that country. What is your overall outlook for the Chinese economy? How will it affect the US economy and US investors?**

China is extremely important to the global economy. China to some degree helped to pull the global economy out of recession with its enormous stimulus. However, I expect China's economy to get worse at some point in the not too distant future



The Chinese economy grew at a very fast rate for long period of time. The Chinese government is extremely concerned that if the growth rate of its economy slows down it is going to have high unemployment. Ironically, though, this country that is supposed to be communist has less socialism than we have in the United States. The social safety net is absent for the most part in China. When people lose their jobs, there are no unemployment benefits and no healthcare provided by the government. The unemployed are not just temporarily inconvenienced while they are looking for a job, they go hungry and they cannot afford to pay for medical bills, so they don't complain; they riot. The government is concerned that high unemployment will bring social instability, which is why they want to maintain full employment and thus grow at any cost. Once you start looking at what is happening in China through this lens, the government's actions start making more sense.

When the global economy slipped into recession, China resorted to the mother of all stimuli. Its stimulus package accounted for 14% of its GDP and was fire-hosed into economy at a very fast rate. Lending went vertical; it went up about 30% in 2009 and 2010. The easiest way to maintain employment is to build, so they built.

China already had a lot of overcapacity going into the recession, but they took that overcapacity even further. You have a lot of empty cities in China. The most infamous city, Ordos, was built for 1.5 million residents, and it is completely empty. China has second-largest shopping mall – the South China Mall - and it is empty.

And there are a lot more examples like that in China. Housing prices went up nationwide. In Beijing, housing prices reached 22 times average income. In Japan, in the late 80s, at the peak of the housing bubble, for reference, that ratio peaked at around 9. In the US in 2007 it peaked at 6.4. For China as a whole, that number is now over 8.

When you try to fire-hose a lot of money into the economy, you are going to misallocate capital. China has been ranked as one of the most corrupt countries in the world, and that guarantees that you are going to have even more misallocated capital. China has a lot of overcapacity in many different areas.

You cannot have vacant cities, empty shopping malls, and a real estate bubble and not have a lot of bad debt. But the bad debt is covered up by growth and will surface when growth slows down or stops. I hear the argument that China only has 30% debt-to-GDP, so it is stronger than many other global economies and has a lot less debt than the United States, for instance. Well, Ireland had very little debt before the financial crisis. Now it is one of the "I"s in the PIIGS, because its government had to bail out the banking system. The difference between Ireland and China is that Ireland had a choice of whether to bail out its banking system, whereas China owns its banking system, so it will have to bail it out.



Why do we care about what happens in China? Several reasons: It is the second largest economy; it is single-handedly responsible for the rising prices in most industrial commodities; and, according to a paper authored by the Reserve Bank of Australia, China is responsible for two-thirds of the global demand for iron ore, one-third of global demand for aluminum, and more than 45% of global demand for coal. Any Chinese decline will tank commodity prices globally. So if your portfolio is heavily exposed to commodities – an asset class that worked well as of late – you are exposed to China.

But China's influence doesn't stop there. Chinese growth has benefited a lot from commodity-producing countries like Canada, Russia, Brazil, Australia and many others. Only a decade ago, for example, exports to China accounted for 5% of Australian exports, now that number is pushing 25%. Readjustment in the Chinese economy will cause a significant readjustment for those countries as well – so if you have a lot of exposure to these countries, you are exposed to China. Finally, China has been the largest holder of US Treasury securities; as its economy weakens, its demand for our fine paper will decline, which will lead to higher interest rates in the US.

**Could China face a banking crisis if, for example, its central bank has to raise interest rates in order to stem rising inflation? Do you see that as a potential threat?**

It is very difficult to see exactly what is going to do China in. It's very difficult to figure out which straw is going to break China's back. China's central bank is raising interest rates because they have significant inflation. When you inject as much money into the economy as the Chinese government did, you are going to have inflation. The more leveraged the system, the more sensitive the economy becomes to higher interest rates.

Here is what puzzles me: Everybody looks at the Chinese government and thinks that it manages its economy so well, and therefore it will find the right mix of interest rates and fiscal policy measures. Americans, however, think that our government has done a horrible job of managing our economy. I doubt if the Chinese government is any better at managing its economy than our government is at managing ours. High interest rates may be what does China in, but who knows? I think it is more important to identify the bubble than the prick that will burst it.

**I want to wrap up with a fairly specific question: What is your outlook for the US markets for 2011? What do you think the return will be on the S&P?**

To have an outlook about the market you have to get a couple things right. You have to get the economy right, and you have to get the response of the markets to



the economy right. I have some doubt about the sustainability of today's recovery, or more accurately about the sustainability of the current growth rate. That is number one. Even if you get economy right, predicting what the market will do in response to the economy is a crapshoot at best.

In addition, we can't find enough good stocks to buy. That is why we hold a lot of cash. (Our cash is a byproduct of our inability to find stocks that meet our criteria and our unwillingness to compromise on what we own, not our belief that we can time the market. We cannot.) So I am, naturally, not excited about the market, though I am excited about specific stocks we own. Despite having written a book that makes an argument that market will be going sideways for another decade or so, I really have no idea where it is going to be next year. It is random.

### **Where do you think interest rates are headed?**

Interest rates are a very interesting subject. The Federal Reserve is desperately trying to bring down long-term rates through QE2, and short-term rates are already at zero. So far, in its latest attempt, the Fed has had little effect on long-term rates, though the Fed will likely keep trying.

I am conflicted on this topic. On the one hand, higher interest rates are not good for the economy in the short run (especially for the housing market, though they are good for savers). In the longer run, however, interest rates that are set by the free market, not by 12 guys sitting in cushy chairs in the Fed's boardroom, are a big positive. For this recovery to be sustainable, we need less government interference and more free market. We don't need a recovery that is orchestrated by the Federal Reserve, because that won't work in the long run.

Also, considering that two largest foreign holders of the US debt are China, which we already discussed, and Japan, which is the most leveraged first-world country [see Vitaliy's presentation on Japan [here](#)], I believe we'll have lower demand for US debt going forward from overseas. We'll likely have higher interest rates.

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