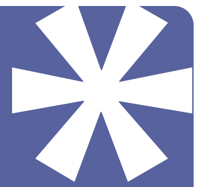


Forecasting Beyond the Credit Crisis – Revisited

Phil Niles re-examines where we currently stand on credit crisis

Philip Niles
Butterfield Fulcrum

As the keen reader may recall, I did a four-part series in Canadian Hedge Watch approximately one year ago which sought to extrapolate beyond the then current market conditions using three key metrics: the Dow/Gold ratio, the stock market Price/Earnings ratio, and the current level of the money supply. Given that many seem to feel that we have moved beyond those gloomy days, I thought it would be worth re-examining where we currently stand using these same three metrics. What do these three statistics now indicate, with the benefit of an additional twelve months of data and a healthy dose of further perspective? We will begin with a quick refresher of those metrics, how they are to be used, and what they can indicate about the direction our markets are heading.

Our Metrics Re-Introduced

The Dow/Gold Ratio – defined simply as the ratio of the Dow Jones Industrial Average to the price of gold in the spot market. It has long been seen as one of the most sought after indicators pertaining to relative value in the market. As we have seen over the past year in a variety of the world's major currencies, holdings in cash can come in and out of vogue and, by extension, the value of the currency can fluctuate as much as stock markets in general. This generally will shift the focus in and out of gold.

The Price/Earnings ratio – probably the most famous financial metric, the P/E ratio is a representation of what price must be paid per dollar of earnings in the underlying investment. In this examination, we will be using the Dow Jones Industrial Average as the underlying proxy for the market as a whole. Frequently, the level of the stock market's P/E ratio can be used as a descriptive statistic pertaining to investor confidence; in good times, investors are willing to pay more for stock market earnings based on the perception that the good times will keep on rolling. Of course, the opposite must hold true in down times and hence why the P/E ratio can act is a good proxy for market exuberance.

The Money Supply – very generally, the money supply is the total amount of money held throughout an economy at a particular point in time. The basic definition involves two major components: the total currency in circulation as well as "demand deposits", or the amount held in current accounts. In this example, we will be using M1 as the definition of the money supply, given its lengthy track record of calculation as well its simplicity.

Our Examination Reprised

We begin with the Dow/Gold ratio. From the initial examination, we found that underlying secular bear markets usually ended with a Dow/Gold ratio somewhere around 5, with the very bottom in the early 1980's being around 1. At the time of writing last year, the Dow/Gold ratio was calculated as follows:

Closing level of the Dow Jones Industrial Average	**9,015.10**
The Price of Gold (US $/oz)	**$843.15**
Dow/Gold Ratio	**10.69**

If we fast forward to the end of June 2010, we are faced with the following figures:

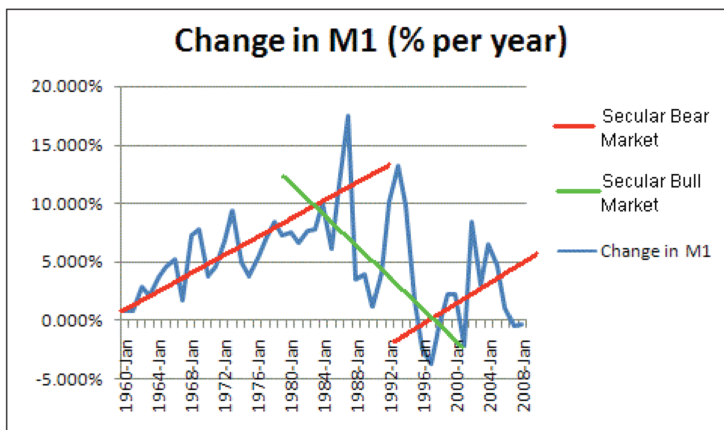
Closing level of the Dow Jones Industrial Average	**10,434.17**
The Price of Gold (US $/oz)	**$1,239.74**
Dow/Gold Ratio	**8.42**

So from the above comparison, we can see that the Dow/Gold ratio has dropped, and indeed it has dropped by more than two full points to rest around 8.42. Most noticeably, and not unsurprising given the weakness seen in the currencies of the world, the price of gold has risen dramatically. While this revised ratio would certainly lend credence to the notion that we are nearing the bottom of a secular bear market trend, history would indicate that we are still not quite through. To reach a ratio of 5, we would need to see the Dow Jones Industrial Average drop to around 6,200 (assuming gold prices hold steady) or see the price per ounce of gold rise to more than $2,000 (assuming a similar absence of change in the Dow). Even more noticeable changes would have to occur to get us down to the all-time low from the early 1980's. As mentioned in the original study, it would likely be a combination of the two that would bring about a lower ratio, but regardless of whether you are a stock market bear or a commodity bull, history is calling for further change.

The price/earnings ratio of the Dow Jones Industrial Average is similarly telling. To recap, at the time of writing the initial article, the Dow was sporting a P/E ratio slightly in excess of 13. As of the end of June 2010, the Dow is reflecting a P/E ratio of approximately 15.6. The potential reasons for this increase in the P/E ratio are many: heightened consumer confidence in the future of the markets, a return of capital to the markets following the credit crisis, and a decrease in DJIA earnings are all potential factors. The important thing to note is that, regardless of the reasons for the change, the ratio has actually increased. From our previous examination from 2009, we found that the bottom of the secular bear markets in recent history featured a P/E ratio on the Dow Jones Industrial Average that was less than 10, even as low as approximately 5. This is a far cry from where the market currently stands and, to be sure, it is striking that the P/E ratio has actually increased over the last year.

The money supply is our third metric for study in this examination and, perhaps, the least understood. If you recall from the study of a year ago, we do not particularly care about the absolute level of M1, but rather the year-over-year change in the level of M1. Most will not be surprised to learn that the absolute level of M1 has risen dramatically over the last year or so. In an effort to stimulate the economy, the powers that be in the United States have released a great deal of cash into the market to easy the liquidity concerns that have been such a plague. But where does that leave us with respect to the underlying secular market trend? Recall the graph from 2009:

Figure 1: Change in the Level of the Money Supply (M1) 1959-2008



Source: The Author (2009)

We identified that the secular bull markets began with peaks in M1 while secular bear markets began with troughs. As such, if the current difficulties in the market were coming to an end, we would expect M1 to be at a peak. Furthermore, we can see that the annual rate of change at the end of the examination period was however around 0%, but one could perceive a general upward shift.

Without further ado, this author can confirm that the US Federal Reserve reports the annual change in M1 from May 2009 to May 2010 to be 7.0%. Certainly this is an increase from what was observed last year, but it is not necessarily at the peak one might expect. The figure of 7.0% is approximately what was witnessed in the early 2000's in the effort to counteract that economic downturn, hardly a standout peak for the statistic. Early in the 1980's, at the close of the last secular bear market, the annual change in M1 hit double digits. Though the secular bear market before that one featured a high single digit annual change in M1, it would be reasonable to expect a figure higher than 7.0% to signal the end of the current secular bear market.

Conclusion

The four-part series from 2009 concluded that there were more difficulties yet to come in the equity markets, using the Dow Jones Industrial Average as a market proxy. Using the same three metrics (the Dow/Gold ratio, the Price/Earnings ratio of the DJIA, and the change in the level of the money supply), the revised examination performed with current data seems to indicate that we are not out of the proverbial woods just yet. All three ratios, when taken together, seem to be indicating a general move in the right direction towards the end of the current secular bear market, however the movement has not been especially pronounced. In fact, as mentioned, the P/E ratio has actually moved in the opposite direction. As a final telling statistic, reprinted below is the table from the original study outlining the last six secular market trends, their average returns, and their durations:

Table 1: Dow Performance During Secular Bull and Bear Markets

Secular Bear Markets	Duration (Years)	Average Yearly Return	Secular Bull Markets	Duration (Years)	Average Yearly Return
1906-1921	16	1.58%	1922-1928	7	17.20%
1929-1949	21	1.69%	1950-1965	16	10.60%
1966-1982	17	1.59%	1983-1999	17	15.30%

Source: The Author (2009)

From the above table, we can see that the average duration of the last three secular bear markets has been a lengthy eighteen years. Eighteen years. Given this fact, and the previously presented statistical analyses, it would seem optimistic to expect the current trend to be already reaching its conclusion. Really, taking this average duration, we would be only just passing the half-way point of the current secular market trend. Without a doubt, there will be bull markets for equity participants to enjoy over the coming years, but the trend seems to be clear: we have got some distance to go yet. *