Economic Viewpoint

Desjardins Economic Studies
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April 2, 2014

Will the bull market continue?

The bull run that the S&P 500 began at the end of winter 2009 has just celebrated its fifth anniversary. If we examine other bull markets, we note that the current one exceeds the average both in duration and in the scope of the gains. There are some grounds for thinking that this upward trend may continue for a while longer, but investors who opt for the U.S. stock market should expect to experience a bear market at one point. That risk always exists in the stock market, however, and it does not prevent equities from being an attractive choice for investors who have some tolerance for risk.

THE BULL MARKET IS ALREADY FIVE YEARS OLD

At the beginning of 2009, investors had reason to feel depressed. It seemed that nothing could stop the financial crisis that started with the bursting of the U.S. real estate bubble and was greatly aggravated by the bankruptcy of Lehman Brothers in September 2008. The stock market correction, which started in the fall of 2007, was looking more and more like a bloodbath when the S&P 500 reached a low of 676 on March 9, 2009. This represented a loss of more than 55% in the space of 17 months.

An umpteenth plan by U.S. authorities to support the banking sector finally emerged as the key glimmer of hope, bringing the crisis to an end and putting the stock market back on an upward trend. More than five years later, this trend is still continuing and the U.S. stock market, after another spectacular boom in 2013, has kept setting new records in recent weeks. At this point, it seems normal to wonder whether this upward trend can last much longer.

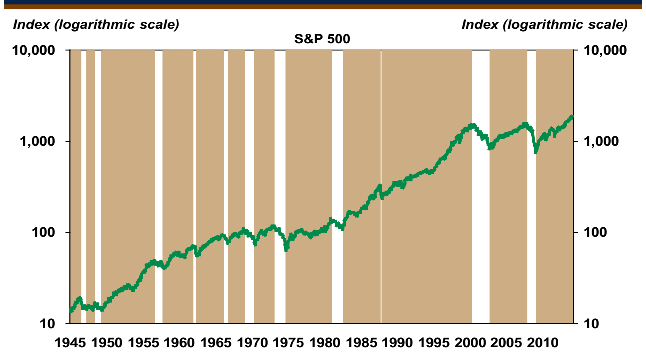
DEFINITION OF A BULL MARKET

It is very difficult to predict the turning points of the stock market, especially the beginnings of downward trends. Sometimes, as was the case in 1980 or 2007, they are caused by a change in the state of the economy. Other times (1987, 2001), they have been caused by an abrupt reversal in investor sentiment. Finally, external shocks (oil crisis, financial crisis) or sector-related problems can bring bull markets to an end. All these types of events are very difficult to predict. Therefore, we have no pretension, in this study, to identify exactly when the stock market will take its next turn.

Nevertheless, it would be interesting to compare the current bull cycle with those that have been observed since the World War II, to see whether this one seems to be living on borrowed time, from a historical perspective.

To make this comparison, we must first clearly define a bull market. We will use the conventional definition, i.e. an increase of more than 20% from the previous stock index low. Similarly, a bear market is defined as a drop of more than 20% from the previous peak. Graph 1 depicts the bull and bear markets of the S&P 500 since 1945. All our calculations are based on end-of-day closing levels.

Graph 1 – Bull markets since World War II



Note: The bull market periods are in beige.
Sources: Bloomberg, Datastream and Desjardins, Economic Studies

François Dupuis
Vice-President and Chief Economist

Yves St-Maurice
Senior Director and Deputy Chief Economist

Mathieu D'Anjou
Senior Economist

514-281-2336 *or* 1 866 866-7000, ext. 2336
E-mail: desjardins.economics@desjardins.com

This study will focus mainly on the S&P 500 index, which is often considered the best benchmark index of the U.S. stock market. Contrary to the S&P 500, which has been on the upswing since March 10, 2009, the Canadian stock market suffered a slump of more than 20% in 2011. The S&P/TSX has since embarked on a new bull run, but it is still of small scope, in terms of both time and gains. Many European stock markets also experienced a significant downturn in 2011, in conjunction with the European financial crisis. As many of these indexes haven't reach new high yet, it is a lot less relevant to ask if the current uptrend is exaggerated. For that reason, the remainder of this study will focus exclusively on the S&P 500. Its trends will in any case have a major impact on the results of the other major stock markets.

COMPARISON WITH OTHER BULL MARKETS

Table 1 shows the scope of the S&P 500 bull markets since World War II. Their have been 10 episodes of bull markets, excluding the current one, over a period of approximately 65 years. On average, the bull markets lasted nearly 1,800 days, i.e. approximately 5 years, and the gains made by the S&P 500 from bottom to top were 162%.

However, these averages are inflated by the extraordinary period from 1987 to 2000, during which the value of the S&P 500 increased more than five-fold. This was followed by a brutal awakening, with the bursting of the technology bubble. If we exclude that event and the weakest of the bull markets, we get an average duration of 4½ years and gains of 126% for the eight remaining bull markets. Still, we note that, even if we exclude the extreme cases, there is large dispersion around the average.

Regardless of the basis for comparison, the current bull market constitutes one of the better ones observed since World War II. If we assume that it came to an end on April 1, 2014, the date of its latest peak, the bull market lasted over five years. In terms of gains, the current bull market is even more impressive, with a gain of 179%.

It is therefore fair to say that the current bull market is already well advanced from a historical perspective. But that does not mean that it is destined to end soon, since there have been three bull markets that lasted more than six years.

A FEW REASONS NOT TO WORRY TOO MUCH

Even though it would seem to have lasted quite a while already, there are a few good reasons to think that the bull market could keep going.

First of all, it is important to keep in mind that the boom started after a veritable collapse. The bear market that lasted from October 2007 to March 2009 was clearly the most painful one since World War II: the S&P 500 lost 57% of its value (see table 1).

At its trough of 676 points, reached on March 9, 2009, the S&P 500 had plunged to a low that had not been seen since 1996. Only a real risk of collapse by the modern financial system could account for such a weak U.S. stock market. Thus, a good portion of the rally of over 175% is explained merely by the fact that the financial crisis came to an end, and that the monetary and government authorities succeeded in avoiding a meltdown of the system.

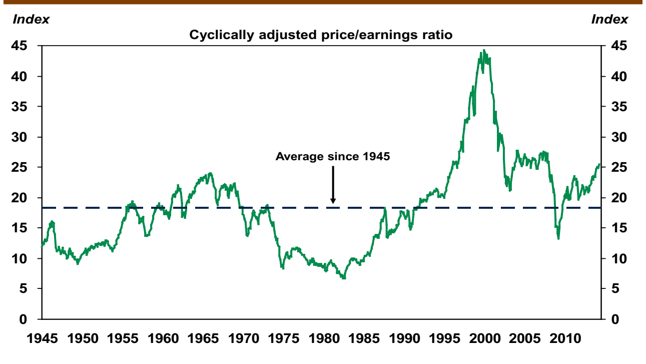
Table 1
Bull runs of the S&P 500 since 1945

Date		*Duration*		*Gain (%)*	*Previous drop (%)*
start	end	days	years		
1947-05-20	1948-06-15	393	1.1	24	-28
1949-06-14	1956-08-02	2,607	7.1	267	-21
1957-10-23	1961-12-12	1,512	4.1	86	-22
1962-06-27	1966-02-09	1,324	3.6	80	-28
1966-10-08	1968-11-29	784	2.1	48	-22
1970-05-27	1973-01-05	955	2.6	74	-36
1974-10-04	1980-11-28	2,248	6.2	126	-48
1982-08-13	1987-08-25	1,839	5.0	229	-27
1987-12-05	2000-03-24	4,494	12.3	582	-34
2002-10-10	2007-10-09	1,826	5.0	101	-49
2009-03-10	2014-04-01	1,849	5.1	179	-57
Average prior to the current bull run		1,798	4.9	162	-32
Average excluding the strongest and the weakest		1,637	4.5	126	-31

Sources: Datastream, Bloomberg and Desjardins, Economic Studies

Investors can also derive reassurance from the fact that, despite the spectacular boom of recent years, the U.S. stock market does not appear to be greatly overvalued. Fundamentally speaking, most price/earnings ratios are relatively close to their historical averages. The cyclically adjusted price/earnings ratio (CAPE) developed by Robert Schiller and calculated using actual earnings of the past ten years, is above average, but it is well below levels seen in the late 1990s (graph 2).

Graph 2 – The S&P 500 is far less overvalued now than it was at the end of the 1990s



Sources: Robert J. Shiller, Yale University and Desjardins, Economic Studies

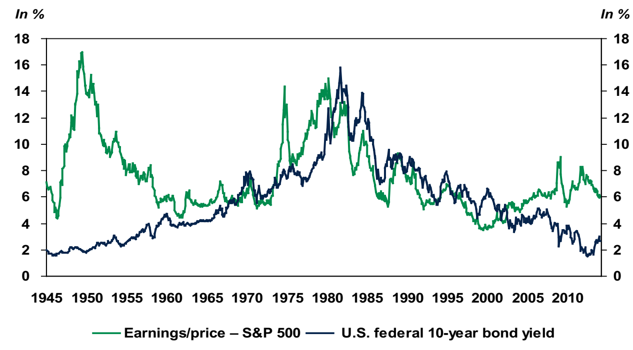
The S&P 500 appears even less overvalued in relative terms. While bond yields remain very low, the ratio between the return promised by the stock market and that promised by a 10-year federal bond is still very high from a historical perspective (graph 3). This could convince investors to continue moving their funds to the stock markets (graph 4).

CONCLUSION: ACCEPTING THE POSSIBILITY OF A BEAR MARKET

The stock market must always be considered a risky investment, as it is subject to significant fluctuations. Investors who allocate a portion of their portfolio to this asset class must always be prepared to watch those assets lose a significant share of their value. That is why this asset class is not suited to all types of investors.

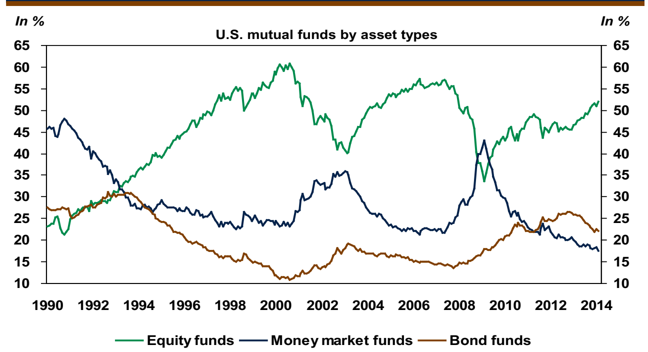
Bear markets are a reality that any stock market investor must be prepared to deal with. After a long and impressive bull run since 2009 and a gain of over 30% in 2013, it is important that investors who choose the U.S. stock market be aware that the growth potential is not as high as it was right after the financial crisis. They should not expect such spectacular gains in the S&P 500 in the years ahead, and they should keep in mind that a temporary correction can occur at any time, even though there are no signs of an imminent drop.

Graph 3 – The S&P 500 still offers a significantly greater return than federal bonds



Sources: Global Financial Data, Datastream, Institutional Brokers Estimate System and Desjardins, Economic Studies

Graph 4 – The weight of equities in U.S. mutual funds could still increase a bit



Sources: Datastream and Desjardins, Economic Studies

Still, the S&P 500 does not appear to be greatly overvalued and its return outlooks in the medium term are still relatively good, especially if we compare them to those of the bond market.[1] Investors who choose the U.S. stock market today should expect to experience a market slump at one point but, nevertheless, they are likely to achieve a worthwhile return in the long run.

Past experience shows that an investor who invested in the S&P 500 at the beginning of the 1950s would have experienced nine bear markets since then, some of them very severe. Despite that, the value of his investment would have skyrocketed. There is no way to tell whether history will repeat itself, but one thing is certain: the stock market will continue to undergo significant fluctuations that will be difficult to predict.

Mathieu D'Anjou
Senior Economist

[1] On this point, refer to: Desjardins Economic Studies, *Economic Viewpoint*, "Long-term major asset class returns – After a lost decade, the stock market seems to offer better opportunities", September 25, 2013, www.desjardins.com/en/a_propos/etudes_economiques/actualites/point_vue_economique/pv130925.pdf.