Intermarket Analysis

Part One, Secular Markets

Overview:

Secular markets are long term cycles lasting a generation or two. 1929-1965 marked one full cycle, and 1966-1999 the next. In each case, the first half was a long sideways grind lasting 10 to 20 years, followed by a dramatic upward surge for another 10 to 20 years.

The long sideways grind is called a secular bear market, and the dramatic upward surge is called a secular bull.

The secular condition is the most important to identify, and it is also the easiest. Consider the following three relationships,

1. The S&P 500 to gold ratio
2. The bonds to gold ratio
3. The S&P 500 to bonds ratio

The following are three point and figure charts, set at a 3% box size. $SPX:$GOLD is the S&P500 divided by the price of gold. This is the most important chart of the three. When we are in a secular bull market it will be rising; in a secular bear (as now) it will be falling:



Next is the BND:$GOLD ratio, showing the average value of bonds divided by gold. As can be seen, this is also falling:



Finally we have the $SPX:BND chart showing the value of the S&P500 divided by the average value of bonds:



These three charts will maintain a trend for years at a time.

A secular bear begins when both bonds and gold outperform the S&P500.

A secular bull begins when both bonds and the S&P500 outperform gold.

The beginning of this secular bear market was completed in May of 2009 when the S&P500 finally began to outperform bonds (this is the last chart).

So, then, we can break the secular markets into four stages (similar to Weinstein’s stage analysis for 4 year business cycles):

1. Stage 1 is a basing action at the end of a secular bear, when stocks and gold outperform bonds. This does not mean that stocks will rise; it only means that they either rise faster than bonds or fall slower than bonds. It basically indicates that the Federal Reserve is out of bullets and can no longer drop interest rates any lower. When interest rates fall, bonds rise; when interest rates rise, bonds fall. Since interest rates have effectively hit zero, they do not have much room left to fall, and bonds cannot continue to rise.
2. Stage 2 is the beginning of a roaring bull market, when stocks and bonds outperform gold. Since both stocks and bonds are vehicles for investing money in businesses, the inflow of money fuels both the stock prices and the businesses behind them, allowing them to sell more stocks and bonds to raise capital.
3. Stage 3 is the topping process for a secular bull. This is the most subtle of the relationships, but for a brief period stocks should go parabolic, as they did in 1929 and 1999. Bonds, as a safe haven investment, start to fall as stocks become “a sure bet” and investors throw caution to the wind. The hyperbolic exuberance drives speculation into commodities and gold starts to rise. Stocks and gold outperform bonds.
4. Stage 4 is the beginning of a secular bear, when the real value of businesses fall and the Federal reserve attempts to cushion the blow by lowering interest rates and devaluing the dollar. While the S&P 500 might make new all time highs in terms of “dollars”, against gold it begins to fall. During this period both bonds and gold outperform stocks.

Put simply, when stocks and gold outperform bonds, we are in a transition between a secular bear and a secular bull.

This was true in 1999, and it is true today. And while the transition from a secular bull to a secular bear can occur in a matter of months, the transition from a secular bear to a secular bull will take years.

Summary:

1. Stocks and gold outperform bonds: transitional market (top of a secular bull or bottom of a secular bear).
2. Stocks and bonds outperform gold: secular bull.
3. Gold and bonds outperform stocks: secular bear.

We are currently in the bottoming stage of a secular bear.

Theory:

The cause of a secular bull or bear is hotly debated, but Ned Davis Research made a fascinating observation cited by Kirkpatrick and Dahlquist in their *Technical Analysis, Second Edition* on pages 166-167: “A high correlation exists between the U.S. birthrate and U.S. stock market performance 46 years later. …this correlation has been very close since the mid 1950s. Should this relationship continue, the birthrate data projects a major stock market bottom around 2020 followed by another major, but slightly weaker rise than the 1980-2000 rise, into about the year 2050.”

In my own reconstruction of the historic birthrate I correlated the bottom at 2017, but my data could be inferior to that used by Ned Davis Research.

The reason makes sense if we think in terms of productive and non-productive ages. Kids in school and people who are retired do not produce economic growth, and those who are retired tend to draw from their investments, rather than add to them. Only those actively in the workforce are actively adding to their retirement investments. The average age, of course, is about 46.

And this brings me to conclude this section with a perverse irony: one would think that a gap in working aged people would create less unemployment, rather than more. The problem is that most jobs are created by small business, and most small businesses are started by people between 35 and 55 (with 46 right in the middle). We have more people unemployed, because we have less people creating jobs.

If this sounds like supply side economics, it is. But that’s for a later discussion.

Practice:

In practice, a secular core investment strategy would be relatively simple – to the point of being boring.

Once a month, review the relative strength of bonds, stocks, and gold using point and figure charts on www.stockcharts.com (a free site).

The following links would need to be cut and pasted into your browser:

http://stockcharts.com/def/servlet/SC.pnf?chart=$SPX:$GOLD,PLPADANRBO[PA][D][F1!3!3!!2!20]&pref=G

http://stockcharts.com/def/servlet/SC.pnf?chart=$SPX:BND,PLPADANRBO[PA][D][F1!3!3!!2!20]&pref=G

http://stockcharts.com/def/servlet/SC.pnf?chart=BND:$GOLD,PLPADANRBO[PA][D][F1!3!3!!2!20]&pref=G

Save those as favorites.

The three ETFs (exchange traded funds) to use would be:

IWM for stocks

GLD for gold

BND for bonds

Hold two of those, avoiding the worst choice. Right now stocks and gold are outperforming bonds, which would mean holding IWM and GLD, and avoiding BND.

Check once a month, yawn, and hold until bonds eventually outperform gold (which won’t likely happen until 2017 to 2020).

The results would greatly outperform the S&P 500 and reduce taxes to a minimum.

With this strategy one should avoid a margin account or leveraged ETFs (the ones listed are not leveraged).