

Leithner Letter No. 175-178 26 June-26 September 2014

Like many of the best market analysts, [Seth Klarman](#) looks at both sides of the issue, the bull and bear case, in depth. “If you’re more focused on downside than upside, if you’re more interested in return of capital than return on capital, if you have any sense of market history, then there’s more than enough to be concerned about,” he wrote [recently]. Citing a policy of near-zero short-term interest rates that continues to distort reality and will have long term consequences, he ominously noted “we can draw no legitimate conclusions about the Fed’s ability to end QE without severe consequences,” a thought pervasive among many top fund managers. “Fiscal stimulus, in the form of sizable deficits, has propped up the consumer, thereby inflating corporate revenues and earnings. But what is the right multiple to pay on juiced corporate earnings?”

As he outlined the bear case, he started to divulge his own analysis that “on almost any metric, the U.S. equity market is historically quite expensive. A sceptic would have to be blind not to see bubbles inflating in junk bond issuance, credit quality, and yields, not to mention the nosebleed stock market valuations of fashionable companies like Netflix, Inc. and Tesla Motors Inc.”

*Comparing the economy and the Federal Reserve’s management of it to the movie *The Truman Show*, where the lead character lived in a false, highly-orchestrated environment, Seth Klarman notes with insight, “Every Truman under Bernanke’s dome knows the environment is phony. But the zeitgeist is so damn pleasant, the days so resplendent, the mood so euphoric, the returns so irresistible, that no one wants it to end, and no one wants to exit the dome until they’re sure everyone else won’t stay on forever.” Then he quotes [Jim Grant](#) who recently noted on CNBC, the problem is that “the Fed can change how things look, it cannot change what things are.”*

[Seth Klarman: Fed Created Truman Show Style Faux Economy](#)
ValueWalk (3 March 2014)

While the U.S. may be rejoicing its daily stock market all-time highs day after day, it may come as a surprise to many that global equity capitalization has hardly performed as impressively compared to its previous records set in mid-2007. In fact, between the last bubble peak and mid-2013, there has been a \$3.86 trillion decline in the value of equities to \$53.8 trillion over this six year time period, according to data compiled by Bloomberg.

Alas, in a world in which there is no longer even hope for growth without massive debt expansion, there is a cost to keeping global equities stable (and U.S. stocks at record highs): that cost is \$30 trillion, or nearly double the GDP of the United States, which is by how much global debt has risen over the same period. Specifically, total global debt has exploded by 40% in just 6 short years from 2007 to 2013, from “only” \$70 trillion to over \$100 trillion as of mid-2013, according to the [Bank of International Settlements] just-released quarterly review.

[Global Debt Exceeds \\$100 Trillion as Governments Binge, BIS Says](#)
Bloomberg (9 March 2014)

The Risk of a Mere Correction – Or of a Severe Bear Market?

“The Australian share market notched up a fresh near six-year high at [today’s] open,” reported *Business Spectator* on 24 April 2014. “The S&P-ASX200 now sits at its highest intraday level since the week of June 9, 2008, eclipsing the intraday high of 5,521 set yesterday.” Is this good news or a bad omen? According to Shane Oliver ([The Risk of a Correction or New Bear Market in Shares?](#) *Oliver’s Insights*, 23 January 2014),

While shares might see a brief 10-15% correction at some point this year, a new bear market is unlikely and as such returns should remain favourable through the year as a whole. ... I have applied the definition that a cyclical bull market is a rising trend in shares that ends when shares have a 20% or more fall that takes more than 12 months to be reversed. A typical cyclical bull market since 1950 has seen shares rise 126% ... and [lasts] four years. So far we are up 37% over 28 months. So history suggests more [upside of share prices] to go.

Oliver elaborates:

Since 2011, shares have been in a cyclical bull market, with a clear pattern of rising highs and lows. ... Some factors [which Oliver specified in his article] could contribute to a correction this year and at the very least more volatility in share markets. While 2010 and 2011 saw roughly 15% and 20% top to bottom falls in shares around the middle of each year, in the last two years corrections were quite mild with a roughly 10% fall around May-June in each year, so maybe we are due for a bit more volatility. ... More fundamentally it’s too early in the economic-investment cycle to expect a new bear market just yet. ... Rising global growth and a pick-up in Australian growth through the year should drive stronger profits, and optimism regarding the global economic outlook and share markets has clearly returned. But we don’t see the signs of vulnerability that become ... precursors to a new bear market ...

Shares are no longer dirt cheap but they are not overvalued either. Price to earnings ratios are up but only to around long term average levels at 14.4 times in Australia (average is 14.1 since 1992), 15 in the US (average is 15.9 since 1992) and 14.1 for global shares (average is 16 since 1992). The gap between earnings yields and bond yields, a proxy for the excess return shares offer, remains well above pre-GFC norms. This is all reflected in our valuations indicators [i.e., the charts and graphs that accompanied Oliver’s analysis] which show markets [are presently] around fair value. ... We seem a long way from the sort of investor euphoria normally seen at major market tops (see also Don Stammer, [It’s Too Early to Call an End to Bull Market](#), *The Australian*, 12 November 2013 and Tom Lauricella, [Is This Bull Cyclical or Secular?](#) *The Wall Street Journal*, 15 June 2009).

Let’s summarise Oliver’s four key assertions:

1. “since 2011 shares have been in a cyclical bull market;”
2. “while shares might see a brief 10-15% correction at some point this year, a new bear market is unlikely and as such returns should remain favourable through the year as a whole;”
3. “shares are no longer dirt cheap but they are not overvalued either;”
4. “history suggests more [upside of share prices] to go.”

Defining Some Key Terms

How to assess these assertions? Is it really true that stock market indices in Australia are not prohibitively expensive? I don't think so. Moreover, I also believe that weak foundations – namely imprudent assumptions and the selective use of data – underlie the bulls' confidence. If instead we adopt cautious assumptions and analyse all relevant data, then one of Oliver's assertions (the third) becomes highly questionable. The diametric opposite conclusion is, I believe, much closer to the truth (or at least a more sensible guideline): at present, stocks in Australia are greatly over-priced, and “investors” – “speculators” is probably a more appropriate term – who buy them at these prices will eventually regret it.

In order to reason to this conclusion, rather than merely assert it, and also to understand how and why it contradicts Oliver's, we must first define four key terms: secular bull market, secular bear market, cyclical bull market and cyclical bear market. [According to Wikipedia](#),

The terms *bull market* and *bear market* describe upward and downward market trends, respectively, and can be used to describe either the market as a whole or specific sectors and securities. A *secular market trend* is a long-term trend that lasts 5 to 25 years and consists of a series of primary trends. A *secular bear market* consists of smaller bull markets and larger bear markets; a *secular bull market* consists of larger bull markets and smaller bear markets.

These basic conceptions are reasonably widely accepted.¹ From them it follows that a *cyclical bear market* is a short-term (that is, less than five years) and downward deviation from a long-term (typically but not invariably upward) trend; similarly, *cyclical bull market* is a short-term and upward deviation from a long-term trend. It also follows that a cyclical bear market can occur during a secular bull market. In other words, over a given long-term (for example, ten-year) period the general trend of stock markets' levels and investors' returns can be upward and positive (bull market); but during that interval one or more bear markets can occur. Similarly, a cyclical bull market can occur during a secular bear market. Wikipedia elaborates:

In a secular bull market the prevailing trend is “bullish” or upward-moving. The United States stock market was described as being in a secular bull market from about 1983 to 2000 (or 2007), with brief upsets including the crash of 1987 and the market collapse of 2000-2002 triggered by the dot-com bubble. In a secular bear market, the prevailing trend is “bearish,” or downward-moving.

A bear market followed the Wall Street Crash of 1929 and erased 89% (from 386 to 40) of the Dow Jones Industrial Average's market capitalization by July 1932, marking the start of the Great Depression. After regaining nearly 50% of its losses, a longer [i.e., secular] bear market from 1937 to 1942 occurred in which the market was again cut in half. Another long-term bear market occurred from about 1973 to 1982, encompassing the 1970s energy crisis and the high unemployment of the early 1980s. Yet another [but cyclical] bear market occurred between March 2000 and Oc-

¹ Investopedia, for example, defines a [bear market](#) as “A market condition in which the prices of securities are falling, and widespread pessimism causes the negative sentiment to be self-sustaining. As investors anticipate losses in a bear market and selling continues, pessimism only grows. Although figures can vary, for many, a downturn of 20% or more in multiple broad market indexes, such as the Dow Jones Industrial Average (DJIA) or Standard & Poor's 500 Index (S&P 500), over at least a two-month period, is considered an entry into a bear market.”

tober 2002. The most recent example [of a cyclical bear market] occurred between October 2007 and March 2009, as a result of the financial crisis of 2007–08.

Secondary trends are [very] short-term changes in price direction within a [longer, i.e.,] primary trend. The duration is a few weeks or a few months. One type of secondary market trend is called a *market correction*. A correction is a very short term [i.e., which occurs over a few weeks or months] price decline of 5% to 20% or so. A correction is a downward movement that is not large enough to be a bear market (ex post). Another type of secondary trend is called a *bear market rally* (sometimes called “sucker’s rally” or “dead cat bounce”) which consists of a market price increase of only 10% or 20% and then the prevailing, bear market trend resumes. Bear market rallies occurred in the Dow Jones index after the 1929 stock market crash leading down to the market bottom in 1932, and throughout the late 1960s and early 1970s. The Japanese Nikkei 225 has been typified by a number of bear market rallies since the late 1980s while experiencing an overall long-term downward trend.

It’s important to note that, in his article of 23 January 2014, Shane Oliver doesn’t define several key terms (particularly “secular bull market,” “secular bear market” and “correction”); moreover, his usage of “cyclical bull market” contradicts Wikipedia’s. Oliver lists (see the updated Table 1 below) “the record of cyclical bull markets in Australian shares since 1894. [Oliver has] applied the definition that a cyclical bull market is a rising trend in shares that ends when shares have a 20% or more fall that takes more than 12 months to be reversed. A typical cyclical bull market since 1950 has seen shares rise 126% ... and last four years ...”

Table 1: Shane Oliver’s “Cyclical” (Actually Mostly Secular) Bull Markets in Australia, All Ordinaries Index, 1894-2014

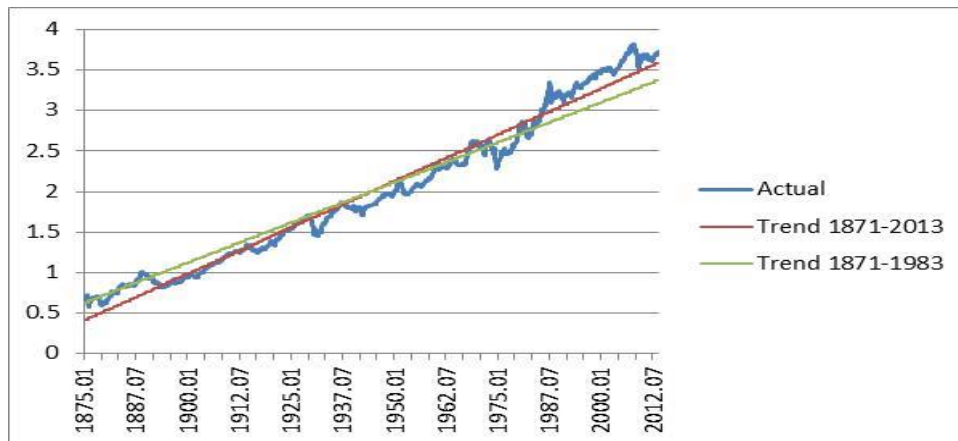
	Interval	Duration
1.	Mar 1894-Jun 1914	20 years, 3 months
2.	Dec 1916-Jul 1929	12 years, 7 months
3.	Aug 1931-Mar 1937	5 years, 7 months
4.	Apr 1942-May 1951	9 years, 1 month
5.	Dec 1952-Sep 1960	7 years, 9 months
6.	Nov 1960-Feb 1964	3 years, 3 months
7.	Jan 1965-Jan 1970	5 years
8.	Nov 1971-Jan 1973	1 year, 2 months
9.	Sep 1974-Aug 1976	1 year, 11 months
10.	Nov 1976-Nov 1980	4 years
11.	Jul 1982-Sep 1987	5 years, 2 months
12.	Nov 1987-Aug 1989	1 year, 9 months
13.	Jan 1991-Feb 1994	3 years, 1 month
14.	Feb 1995-Mar 2002	7 years, 1 month
15.	Mar 2003-Nov 2007	4 years, 8 months
16.	Mar 2009-Apr 2014	5 years, 1 month

Table 1 lists the interludes that Oliver defines as “cyclical bull markets. He’s quite right – since 1950, they’ve averaged a bit longer than 4 years. Why does he bifurcate the series in 1950? He doesn’t tell us, but the answer is clear: *ten of the intervals – and all that occurred before 1950 – are, by Wikipedia’s conception, not CYCLICAL bull markets: they’re SECULAR bull markets – a term, remember, that he doesn’t define. Ten of these 16 intervals, in other words, lasted at least five years.* Oliver’s most important omission, it seems to me, is that he neither defines logically nor specifies the trend that establishes and ends what he regards as “cyclical” bull market.

Let's Now Apply Our Definitions

Why are Oliver's omissions so significant?² *Only by omitting key concepts and data can he support his second and particularly his third assertion: if he examined all relevant data and included all relevant definitions, his bullish case would collapse and a diametrically opposite conclusion would prevail.* To see this, consider Figures 1 and 2. Figure 1 plots all available relevant data – namely monthly observations of the All Ordinaries Index (logarithmic scale) since 1871.

Figure 1: All Ordinaries Index, January 1871-December 2013 (log scale)

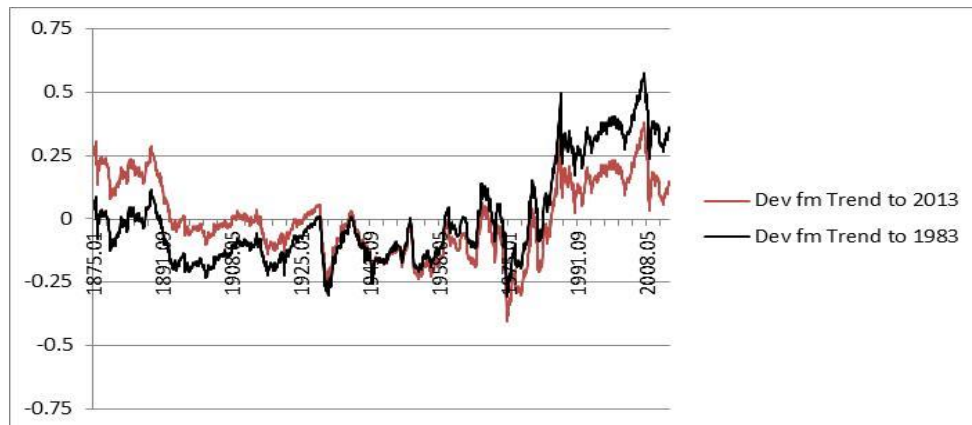


Two very long-term trends (best-fitting lines) accompany the data in Figure 1. (Each trend line is “best-fitting” in the sense that the sum of all deviations from a given trend is 0.0.) The first encompasses the entire series (January 1871-December 2013), and the second covers the interval January 1871-August 1983. There’s no question that very long-term trends describe the All Ords. In particular, it’s unarguable that *these* trends fit the actual data extremely and equally well ($R^2 = 0.98$ for 1871-2013 and $R^2 = 0.97$ for 1871-1983). Figure 2 plots the deviations (also known as residuals, also shown in logarithmic terms) from these two best-fitting lines.

Figure 1 and Figure 2 expose a critical – and I think fatal – weakness of Oliver’s (and, more generally, Australian bulls’) upbeat point of view. *Since the early 1980s (more specifically, since August 1983) ALL of the actual observations are “above trend.” What’s more, as time passes after 1983, deviations from the trends become steadily bigger.* Empirically, I don’t think that August 1983 has any particular importance; substantively, however, I think it’s enormously significant that the deviations from both trends are continuously above-trend since the early 1980s. *Also note particularly from Figure 2 that the extent of the above-trend deviation – in plain English, the overvaluation of the All Ordinaries Index – is presently not as great as it was on the eve of the Crash of 1987 or GFC; but it’s now as great as or greater than it’s been 78% of the time since January 1871.*

² I’ll ignore two other important weaknesses of Oliver’s analysis. The first is his reliance upon one-year price to earnings ratios, and his complete omission of long-term and cyclically-adjusted PE ratios (CAPEs). The latter show that the S&P 500, for example, is drastically overvalued (see [Letter 163-166](#), particularly pp. 25ff, and William Hester, [Does the CAPE Still Work?](#) December 2013). Indeed, “the Fed has produced what is now the most generalised equity valuation bubble that investors are likely to observe in their lifetimes” (John Hussman, [The Future is Now](#), 28 April 2014). Secondly, Oliver thinks that one-year PE ratios, as well as “the gap between earnings yields and bond yields, a proxy for the excess return shares offer, [which] remains well above pre-GFC norms,” tell us something meaningful. John Hussman ([Long-Term Evidence on the Fed Model and Forward Operating P/E Ratios](#), 20 August 2007) convinces me that they don’t. Accordingly, Oliver’s “valuation indicators which show markets [are presently] around fair value” are at best misleading and at worst are simply and diametrically wrong.

Figure 2: the All Ordinaries Index, January 1871-December 2013 (log scale): Deviations from Trends



Recall our definitions' basis: "a secular market trend is a long-term trend that lasts 5 to 25 years and consists of a series of primary trends. A secular bear market consists of smaller bull markets and larger bear markets; a secular bull market consists of larger bull markets and smaller bear markets." Since the early 1980s a secular bull market (extended by cyclical bull markets preceding the Crash of 1987 and the GFC, and punctuated by cyclical bear markets in their immediate wake) has prevailed in Australia. Given our operational definition of secular bull market as an uninterrupted monthly series of above-trend measurements, the post-1983 secular bull is the longest in Australian history; indeed, its duration exceeds the definition's 25-year maximum. The second-longest ran from January 1871 to June 1893 – a period of 22 years and 5 months. Although its final 20 years were quite mild, the longest secular bear market ran from January 1937 to May 1968, i.e., 31 years 4 months; and by far the severest (that is, more severe than the Great Depression and GFC) encompassed 1974-1978.

At this point it's useful to rebut an objection that bulls would likely raise. Never mind our definitions and their implications, they might say: it's absurd to characterise the period 1937-1968 as a secular bear market. After all, the 1950s and 1960s in Australia were halcyon decades of economic stability and growth; specifically, it was during these years that large numbers of native-born Australians (and many more arrivals from overseas) began to adopt what we today recognise as a quintessentially middle-class lifestyle and standard of living. A bear market throughout these prosperous years? Rubbish!

As a first point of rebuttal, the interval(s) of time which we choose to analyse does indeed determine the slope of our trend lines; and deviations from trends, in turn, determine which intervals we dub secular bulls, secular bears, etc. By using data selectively, we too could tailor a conclusion that flattered our fond hopes rather than attempted dispassionately to describe reality. In this important sense, my conclusions are just as time-dependent as Oliver's. *How to minimise this "time-bias"?* Use all of the data that are both relevant and available. Oliver uses snippets and focusses heavily upon the present; in sharp contrast, I use all available data and use the past – including the distant past – to inform the present. By my way of thinking, it's entirely possible that much time must elapse before we can confidently label a given interval as a secular bear, cyclical bull, etc.; and as more time elapses, it's also likely that we'll revise our assessments.³

³ Legend has it that, whilst preparing Richard Nixon for his historic visit to China in 1972, Henry Kissinger mentioned that Chou En-Lai was an avid student of French history. Not long after he arrived in China, Nixon met Chou in the walled garden of the Forbidden City. As they walked silently around the lily ponds, Nix-

A second response is that the bulls protest too much. Although they would likely deny that a *bear* market marked 1937-1968, and perhaps even that such an extended bear is even possible, they happily affirm – even celebrate – a 30-year *bull* market. Look again at Table 1: by Oliver’s reckoning, a bull has existed more than 80% of the time since November 1976. An inconsistency thus underlies this criticism: long bull markets are possible, but long bears aren’t. A third response presages one of my major conclusions: in Figures 1 and 2, all the observations for 1937-1968 lie below the 1871-2013 (but not the 1871-1982) trend line because more recent (since the early 1980s) observations all lie above it; the overvaluation of the All Ordinaries Index, caused mostly by a secular bull market since the early 1980s and partly by a cyclical bull since 2011, steepens the slope of the 1871-2013 trend – but not of the 1871-1983 trend (of which more below). *Only in light of the secular bull market since the early 1980s, in other words, can we characterise the years 1937-1968 as a secular bear market; only in light of the overvaluation since the early 1980s can we speak of undervaluation in 1937-1968.* The 1871-1983 trend line confirms this: absent the post-1983 secular bull, the characterisation of 1937-1968 as a secular bear disappears.

The post-1983 secular bull and the post-2011 cyclical bull (see the next paragraph) have combined to push the All Ordinaries Index far above its 1871-2013 trend. How far above? *According to Figures 1 and 2, in order to revert to this trend, the All Ordinaries Index must fall to 3,800.* That’s a fall of ca. 30% from current (May 2014) levels. Perhaps that will happen quickly, via a cyclical bear; perhaps it will occur slowly, via a secular bear. Or perhaps it won’t transpire at all – maybe, in other words, something occurred in the early 1980s and remained in place thereafter that has permanently shifted upwards the index’s “fair value.” Memo to bulls: unless you utterly reject the logic and evidence that underlies Figures 1 and 2, you MUST hang your hat upon this (“it’s been different since the early 1980s”) rack. By definition, the sum of deviations from a trend is 0.00; accordingly, deviations from a trend subsequently regress to the trend. In plain English, if the trend 1871-2013 as plotted in Figure 1 remains in place and extends into the future, then as time passes “above trend” observations will return to – and indeed fall below – the trend. *Bluntly, only if stocks have reached a permanently high plateau (to borrow an infamous phrase confidently uttered not long before the Crash of 1929) and things really are different this time, such that the 1871-2013 trend no longer prevails, can owners of Australian stocks avoid either a cyclical or secular bear market.*

Figures 1 and 2 thus affirm Oliver’s minor conclusion – but emphatically reject his major one. Since late 2011 a cyclical bear market (that is, a 20% rise vis-à-vis the cyclical bear market low of March 2009) has indeed prevailed. Is this good news? *Not when you consider it in the wider context of the longest secular bull market in Australian history.* The combined effect of the secular and cyclical bulls has pushed deviations from the two trends to very high (in a long-term historical context) levels; in plain English, the combined effect of the secular and cyclical bulls has now pushed Australian stocks to an egregiously overvalued level. *Whether one uses the 1981-2013 or the 1871-1983 trend, the deviation from the trend (Figure 2) is now greater than at any time except the eve of the 1987 Crash and the eve of the GFC.* In effect, Shane Oliver sees a few trees (the cyclical bull since late 2011) but completely overlooks the massive forest (the secular bull since 1983); as a result, the secular + cyclical bull markets’ cumulative overvaluation completely escapes him.

Note from Figure 1 that the 1871-1983 trend is lower (and in Figure 2 that the deviations from the trend since 1983 are therefore larger) than the overall (1871-2013) trend. What’s occurred since 1983 that has pushed the All Ords well above its trend to 1983? The bulls’ answer reveals three articles of the Australian mainstream’s faith. First, the reforms commenced by the Hawke-

on recalled Kissinger’s aside. To break the ice, he asked Chou what he thought had been the impact of the French revolution upon Western civilisation. Chou carefully considered the question for a few moments. Finally he replied: “What was the impact of the French revolution upon Western civilisation? It’s too early to tell.”

Keating governments and continued by the Howard government have cumulatively transformed the Australian economy from an also-ran into a world-beater. Since the early 1980s the Australian economy has allegedly become and remained increasingly sound; accordingly, and secondly, for the past thirty years its financial markets have mostly (except during infrequent and brief cyclical bear markets) tended to generate robust returns. Finally, the mainstream crows (albeit not so confidently or loudly since the events of 2008-2009!) that no clouds – never mind storms – seriously threaten Australia’s “strong fundamentals;” for this reason, they believe and as Shane Oliver apparently believes, that strong returns from its financial markets will apparently continue indefinitely.

Although I think that the mainstream has exaggerated these reforms’ comparative breadth and depth (since the early 1980s many Western countries have undertaken roughly similar reforms; and some, like New Zealand, have done so much more comprehensively), and that it has thereby over-estimated their salutary effects, I don’t deny that some reforms and some beneficial effects have indeed occurred. My criticism is that the mainstream either downplays or denies both the existence of certain invidious “reforms” since the early 1980s (particularly the vast growth of the size of fractional-reserve banks in Australia, the Reserve Bank of Australia’s increasingly aggressive creation of inflation and suppression of rates of interest, etc.) and these “reforms” baleful consequences (namely the vast growth of the financial sector, of household, corporate and government indebtedness and the inflation of assets’ prices). Australian households’ balance sheets, to cite but one example, are unquestionably much *bigger* today than they were a generation ago. That’s primarily a consequence of the RBA’s inflation, and secondarily the result of Australians’ consenting acts of capitalism. Net of the inflation – that is, thanks to their own efforts and the benefits of technology, etc. – over time they’ve clearly become richer. Equally unarguably, they’re much more *leveraged* (debt-laden) now than they were then. Assets have grown, but liabilities have grown even more quickly. Arguably, jobs are also less secure. Hence the paradoxical result of these reforms: Australians are wealthier but their finances are more fragile – and thus vulnerable to severe breakage during a crisis.⁴

What if all the excesses accumulated since the early 1980s – that is, Australian governments’ fiscal profligacy, the RBA’s monetary recklessness, households’ greatly increased leverage, etc. – suddenly disappeared? What, in other words, if the previous (1871-1983) trend again prevailed? *Figures 1 and 2 allow us to make a crude guess: they imply that the All Ordinaries Index would fall to ca. 2,300.* Figure 1’s current estimate of the All Ordinaries Index’s “fair value” (i.e., ca. 3,800 using the 1871-2013 trend and 2,300 using the 1871-1983 trend) not only corroborates the estimates that I’ve presented elsewhere using different methods (see, for example, [Letter 163-166](#) and [Letter 114-116](#)); it also confirms that at the low-point – so far? – of the GFC (i.e., the first quarter of 2009, when the index fell to ca. 3,200 versus a trend value of 2,450) the AOI wasn’t, on a long-term historical basis, cheap. When was it last really cheap? During the mid-1970s.

Many Reckon That If It Happened Before the Second World War Then Nothing Like It Will Ever Recur

Before proceeding, let’s eviscerate a common – and lame – criticism of our logic and evidence. Bulls once put it to me all the time. “You can’t use data from before the Second World War,” they’d say. “The economy was totally different back then; most importantly, the Great Depres-

⁴ This assessment recalls a revealing joke. A journalist once asked Mikhail Gorbachev how – in one word – he would describe the current health and future outlook of the Soviet economy. “Good,” he confidently beamed. Then the journo asked how – this time in two words – Gorbo would characterise it. “Not good,” he meekly confessed (see “A Healthy Dose of Reality,” *The Age*, 2 February 2004).

sion, or anything remotely resembling it, never can and never will recur.” More generally, for decades until 2007, the mainstream – including and perhaps especially the world’s most renowned and revered economists – insisted that the alleged stability of the economy since the Second World War constituted irrefutable evidence of the triumph of the welfare-warfare state. Much like George W. Bush and his neoconservative henchmen, mainstream economists not only declared “mission accomplished;” they also ignored or ridiculed anybody who dared to question their “victory.” “Macroeconomics was born as a distinct field in the 1940s as a part of the intellectual response to the Great Depression,” said Robert Lucas, winner of the 1995 Bank of Sweden Prize in Economic Sciences in Memory of Alfred Nobel, in his Presidential Address to the American Economic Association (2003). He continued:

The term [macroeconomics] then referred to the body of knowledge and expertise that we hoped would prevent the recurrence of that economic disaster. My thesis in this lecture is that macroeconomics in this original sense has succeeded: its central problem of depression prevention has been solved, for all practical purposes, and has in fact been solved for many decades ...

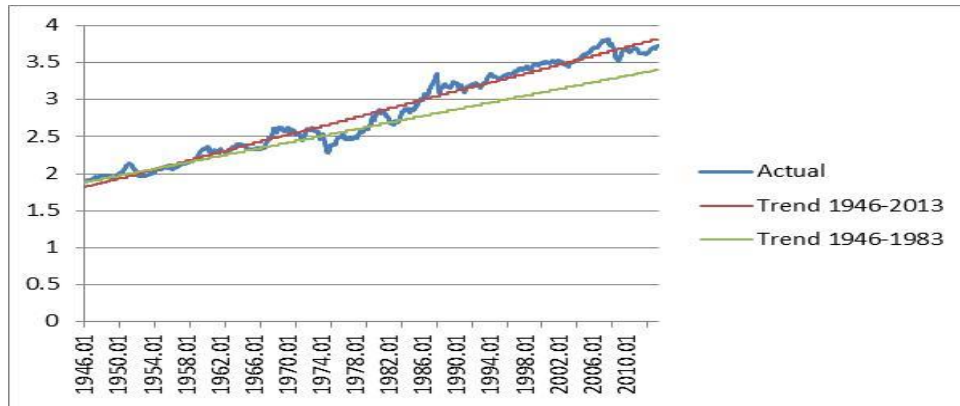
Since 2008-2009, nobody who inhabits the real world has accepted that contention. The trouble, of course, is that the world’s most renowned mainstream economists – who over the past decade have tended to become chairs of the Federal Reserve’s Board of Governors – inhabit the imaginary world of abstract models. It’s now blindingly obvious to many people – but not to most economists, politicians, central bankers, etc., that the vaunted “stability” of the past few decades to 2007 was much more apparent than real. Seeming stability did not reflect the *success* of the mainstream’s interventionism: it reflected the *artificiality* of the conditions these misguided policies created. Similarly, for years the hedge fund swindler Bernard Madoff also generated amazingly stable results – until reality suddenly and brutally intruded. Since 1935, the world’s biggest Ponzi scheme, America’s Social Security Administration, has reliably paid pensions. But actuarially it’s long been hopelessly bankrupt (see, for example, Bruce Krasting, [Social Security Is Going Broke Faster Than You Think: 12-Year Cash Deficit Is Nearly \\$2 Trillion](#), *David Stockman’s Contra Corner*, 25 April 2014). More generally, [the U.S. Government has long been morally and materially bankrupt](#) in the sense that decades ago politicians made financial promises to Americans – and diplomatic commitments to foreigners – that tomorrow’s politicians cannot possibly keep.

For seven decades, Communism in the Soviet Union was also “stable” and “successful” – and, notoriously, prominent mainstream economists like Paul Samuelson lauded the Soviet economy. But it was hardly durable, and its sudden and unexpected (to Western elites) collapse demonstrated – just as Ludwig von Mises foresaw in “Economic Calculation in the Socialist Commonwealth” (1920) and *Socialism: An Economic and Sociological Analysis* (1922) – that it had always been unworkable. How, then, do I respond to the mainstream’s lame criticism? By stating the obvious – namely that it’s diametrically incorrect. We mustn’t ignore any valid and reliable data; we must include all such data. If we really think that contemporary central banks’ policies or central governments’ legislation can repeal the laws of economics – and in particular if we continue to believe that the Great Depression or something resembling can never recur – then we seriously delude ourselves – and set the stage for great losses of investments.

But no matter: let’s humour the mainstream by ignoring everything before the Second World War. Figures 3 and 4 replicate with data since January 1946 the analysis summarised in Figures 1 and 2. Do they help the bullish mainstream’s case? If you believe that the period before 1946 is ancient history and that ancient history is bunk, then a vital choice confronts you. Do you also believe that economic and financial developments since 1983 have been unambiguously good, and that as a consequence economic and financial fundamentals in Australia are basically sound,

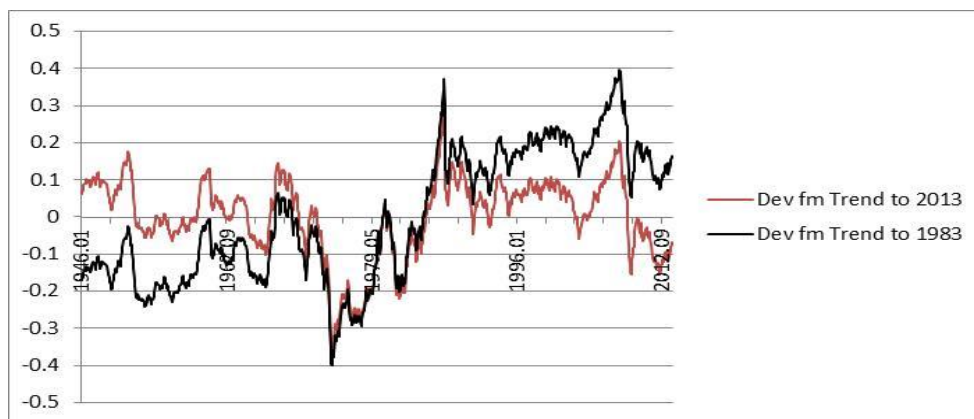
and because they're sound nothing much can, should or will change? If so, then the trend 1946-2013 provides the appropriate basis for your estimate of the All Ordinaries Index's fair value. What does it tell you? *That the Index has been undervalued – sometimes greatly – since 2009, and that today (May 2014) it remains significantly so. To what extent? Given your assumptions, the Index's fair value is 6,450 – not far from the all-time high it reached in late-2007.*

Figure 3: the All Ordinaries Index, January 1946-December 2013 (log scale)



Unsurprisingly, given the assumptions that underlie it, the “bullish” (1946-2013) trend in Figures 3 and 4 conforms reasonably well to the mainstream’s account of the stock market’s history since the 1970s. A cyclical bear has stalked the Australian market since 2009, but a cyclical bull has appeared since 2011. Indeed, with only a few very brief interruptions, the trend confirms that a secular bull market existed from the early 1980s until the eruption of the GFC. The longest and by far the strongest secular bear market occurred during the Whitlam-Fraser years. The most egregious periods of overvaluation appeared on the eves of the Crash of 1987 and GFC.

Figure 4: the All Ordinaries Index, January 1946-December 2013 (log scale): Deviations from Trends



But what if you believe that economic and financial developments since 1983 have been bad as well as good (and on the whole at least as bad as good), that consequently economic and financial fundamentals in Australia are not nearly as sound as the mainstream wishes that you’d believe, and because to a significant degree they’re unsound economic sanity and reality will prevail again one day? In short, what if you believe that the welfare-warfare state is evil and that its agents and mascots are thieves? If so, you’re hardly alone and the trend 1946-1983 provides the appropriate basis for your estimate of the All Ordinaries Index’s fair value. What does it tell you? That the trend 1946-1983 confirms that a secular bear market has existed since the early 1980s,

and consequently that today the All Ordinaries Index is – indeed, has long been – drastically overvalued. *To what extent? Given your assumptions, the All Ordinaries Index's current fair value is 2,500 – which it first reached in May 1997, which it hasn't seen since September 1998 and virtually the same estimate of fair value, it's worth noting, as in Figures 1 and 2 (and also of my previous analyses).* Note as well, therefore, that in this critical respect this bearish result isn't time-dependent.

Time Now to Anticipate and Rebut Another Criticism

A particular sentence in the previous paragraph (“In short, do you believe that the welfare-warfare state is evil and that its agents and mascots are thieves?”) will likely cause many bulls to roll their eyes and close their minds. “That’s the stupidest thing I’ve ever heard,” some will smirk. “It’s extreme,” others will add, and thereby conclude “only an insignificant minority could possibly believe such a crazy thing; moreover, the mainstream comprises a majority, the majority is unassailably right and the minority is indisputably wrong. Consensus rules!”

How to rebut this criticism? By taking seriously the first part of sentence that follows it: “If so, you’re hardly alone ...” *Bulls might deny it, but nonetheless it’s true: ever fewer people trust the benevolence and efficacy of their rulers, and growing numbers don’t just doubt it; they flatly deny it. A naïve trust of the state and its agents, in other words, has long been but is now rapidly ceasing to be a mainstream and majority position.* “Again and again,” wrote Theodore Dalrymple in that extremist minority publication, *The Australian* (“Inelegance of the Bureaucrat Meets Menace of the Mafia,” 23 April 2014), Britain’s “political class is revealed as financially unscrupulous and grasping, not missing the slightest opportunity to enrich itself at public expense, leading the electorate to the conclusion it is out exclusively for itself and cares not at all for the good of the country.”

In the U.S., “37% of likely voters now fear the federal government, according to a new *Rasmussen Reports* national telephone survey. 47% do not, but another 17% are not sure.”⁵ 54% consider that today the federal government is a threat to rather than a protector of individual liberty. Just 22% regard the government as a protector of individual rights – down from 30% in November 2013. Slightly more (24%) are undecided. As recently as December 2012, American voters were evenly divided on this question: 45% said the federal government was a protector of individual rights, while 46% described it as a threat to those rights. More generally, two-thirds of voters (67%) view the federal government as a special interest group that looks out primarily for its own interests. Just 17% disagree and 15% are undecided. “Only 19% now trust the federal government to do the right thing most or nearly all the time, down from 24% in June of last year. Eighty percent (80%) disagree; 44% trust the government to do the right thing only some of the time and 36% say it rarely or never does the right thing” (see [37% of Voters Fear the Federal Government](#), *Rasmussen Reports*, 25 April 2014).

Gary North ([Will Facebook Bring Down the Government?](#) *Gary North's Specific Answers*, 26 April 2014) considers the implications of this emerging majority's rise:

I am rarely impressed by polls, because I know how the pollsters can structure the questions to affect the outcome. But when the same firm asks the same question, and the results are significantly different, I pay attention. *Something fundamental may be*

⁵ A [soon-to-be published article](#) by Martin Gilens of Princeton University and Benjamin Page of Northwestern University nexamines issues over the past 30 or more years and identifies the public's versus elite and interest-group preferences. They find that politicians don't really care what the public thinks: when insiders' and outsiders' views differ, the elite's almost always prevail. *The U.S., in short, is NOT a democracy: it's an oligarchy.* Ironically, the National Security Agency – [which uses illegal and perhaps unconstitutional means to snoop](#) – is the only agency of the U.S. Government that gives a damn what people think and say!

changing. As percentage changes, these are remarkable. We are seeing a fundamental re-thinking of the federal government by the American public. ... If this decline of trust in the government, especially trust in Congress, is part of a long-term pattern, then within a decade, trust in the federal government is going to be almost non-existent. The rate of decline in confidence is remarkable. Anything that declines [as much as 3% per year] is in big trouble. But anything that declines by five percentage points in a year is not simply in big trouble; it is bordering on the edge of collapse.

When 80% of the voters think that the federal government cannot be trusted most of the time, we are talking about a seismic shift with respect to public opinion. *There is no way to restore faith in the federal government at this point. When only one fifth of the population trusts the government, legitimacy is draining away. Yet it is legitimacy, above all, which persuades people voluntarily to cooperate with the rules and regulations of the government. If the general public is convinced that the federal government is not trustworthy, then the willingness of the public to continue to obey the rules of the federal government is going to decline. ...* Passive resistance will bring down any institution. This was the insight of [Saul Alinsky](#) a generation ago, and it was the insight of Mohandas Gandhi in the 1920s and 1930s. *When people withdraw their support from an institution because they believe that the institution is no longer trustworthy, that institution's days are numbered. ...* The statist are going to lose the ideological war. ... It is simply a matter of time. Our deliverance draweth nigh [italics added].

Four Conclusions

1. "Since 2011," said Shane Oliver in [The Risk of a Correction or New Bear Market in Shares?](#) (*Oliver's Insights*, 23 January 2014), "shares have been in a cyclical bull market." I agree – but hasten to add that this isn't, as Oliver implies, good news.
2. "While shares might see a brief 10-15% correction at some point this year, a new bear market is unlikely and as such returns should remain favourable through the year as a whole." I don't know whether a correction will occur at some point this year. However, I strongly suspect something that Oliver ignores (and might deny). A severe bear market isn't just likely: eventually it's virtually inevitable.
3. Why? Because logic and evidence convince me that Australian shares are not just greatly overvalued: overvaluation has reached severe levels. I thus reject Oliver's claim that "shares are no longer dirt cheap but they are not overvalued either."
4. Oliver may be right: given that a cyclical bull market is presently underway, perhaps history does indeed "suggest more [upside of share prices] to go." But if this is true in the short term, it's equally true that, longer term, Australian financial history also – and more strongly – suggests that there's plenty of downside to come.

The bullish mainstream discounts or ignores the GFC: thanks to the RBA's and Commonwealth's "stimulus," they insist, things are basically fine; moreover, there's no good reason why they shouldn't stay that way. Accordingly, a correction that reasonably quickly reverses is the biggest risk that faces Australian investors. In sharp contrast, I and others conclude that things aren't fine. Indeed, a secular bear market (i.e., an eventual drop of up to 50% that takes years to overcome) is the biggest risk that Australian investors confront.

My stance is bearish not just because I regard the "reforms" since the early 1980s as at best a mixed blessing, and because the "stimulus" since 2007 has set the stage for another reckoning. I'm sceptical not merely because – like ever more people – I fear and loathe welfare-warfare states' wasteful profligacy and murderous interventionism. Ultimately, I'm cautious because the socialism which subsumes the mainstream's articles of faith was long ago consigned to history's

rubbish bin. I – like an apparent majority of people in the U.S., and growing numbers in Australia, Britain, Canada and elsewhere – therefore reject the bulls’ tri-partite creed. This creed is so obviously and transparently absurd that it’s a wonder that anybody with half a brain could possibly take it remotely seriously. Their creed claims that the state’s agents are benevolent; that they detect economic and financial trouble before it occurs; and that they undertake timely and appropriate preventive action that ably steers the ship clear of storms and safely into harbour. Accordingly, a related article of the mainstream’s faith is thus that the CPI, rates of interest, etc., simply cannot – or somehow will not –revert to levels that often prevailed until the early 1980s.

Logic – not to mention prominent events in 2007-2009 – utterly mocks the bulls’ trinity. Before 2007-2009, the mainstream derided the very idea that a financial and economic crisis was remotely possible; today, they can no longer credibly do so. Today, they stridently insist that the Western welfare-warfare state remains solvent; for how long will they grasp at this straw? Bears of my ilk surely stand on firmer ground. We contend that the state and its agents do no good and much harm: they routinely lie, cheat, steal and above all kill (see, for example, John Crudele, [Fraud Runs Rampant in Census Bureau](#), *The New York Post*, 21 April 2014). We know that our rulers are fallible: in the decades before 2007 they denied that their actions could or would create serious trouble; in mid-2007 they still hadn’t the slightest idea that their chickens were coming home to roost; and since 2008-2009 their fiscal and monetary recklessness – that is, more intense versions of the bad policies that caused trouble in the first place – have worsened an already-bad situation. Above all, we know what the bulls stridently deny: interventionist policies inevitably fail.

Wishful thinking is not a sound basis of intelligent action. If you blithely ignore risks and financial history, then they’ll surely bite you; but if you mind the downside then the upside will mind itself. Investors reap returns not by looking upwards or pretending they can peer beyond the horizon, but by testing the ground under their feet. The results of any plausible test should concern them – and prompt them to take defensive action. Australia’s economy and financial system (like its American, Chinese, European, Japanese, etc., counterparts), and therefore its financial markets, are to significant degrees Ponzi schemes and Potemkin villages. To cite three of many examples: [Deutsche Bank’s €55 trillion \(\\$US75 trillion\) of gross exposure to various derivatives is 20 times greater than Germany’s GDP](#); [staff at the U.S. Federal Reserve have rigged the S&P 500](#); and [staff of the Securities and Exchange Commission are inside-traders](#) (see also [From Outside or Inside, the Deck Looks Stacked](#), *The New York Times*, 26 April 2014). If market-rigging and inside-trading are crimes when employees of corporations allegedly attempt them (as in the so-called “[LIBOR scandal](#)”), then why aren’t they when the state’s agents actually achieve them?

The Leviathan state constantly unleashes torrents of policies and erects mountains of legislation. Confusing damaging activity and worthwhile achievement, it flouts but can never repeal the laws of sound economics and finance. As James Grant phrased it, our rulers and their mascots in the universities and mainstream media try to change *how things look*, but they cannot alter *what things are*. Our overlords can strut, bluster, conjure and bully as much as they please: but they never have, cannot now and never will transform water into wine. Ceaselessly printing money and then handing it to the government and its dependents to spend is not a recipe for recovery. Still less is it a program for prosperity. Quite the contrary: it is a certain path to penury. When outsiders realise that the state is a false idol and that its insiders are not our saviours but rather the architects of our misfortunes, financial markets and investors’ returns will – to put it mildly – adjust.

Chris Leithner