Dow 30 Record Highs

Adam Hamilton October 6, 2006 3209 Words

Over the past couple of weeks a curious sort of frenzy has erupted around the venerable Dow Jones Industrial Average first challenging and then surpassing its all-time record highs. Judging by the overwhelming financial-media coverage, there was no more important event on the planet to discuss in recent days.

Case in point was CNBC's exhaustive coverage of the Dow 30's recent march to record territory. Last week, every trading day was given a unique catchy name in the morning as hosts and commentators breathlessly anticipated whether or not that would be The Day. During the trading days, breaking news alerts would cover the bottom quarter of the screen whenever the Dow inched over 11700 or so.

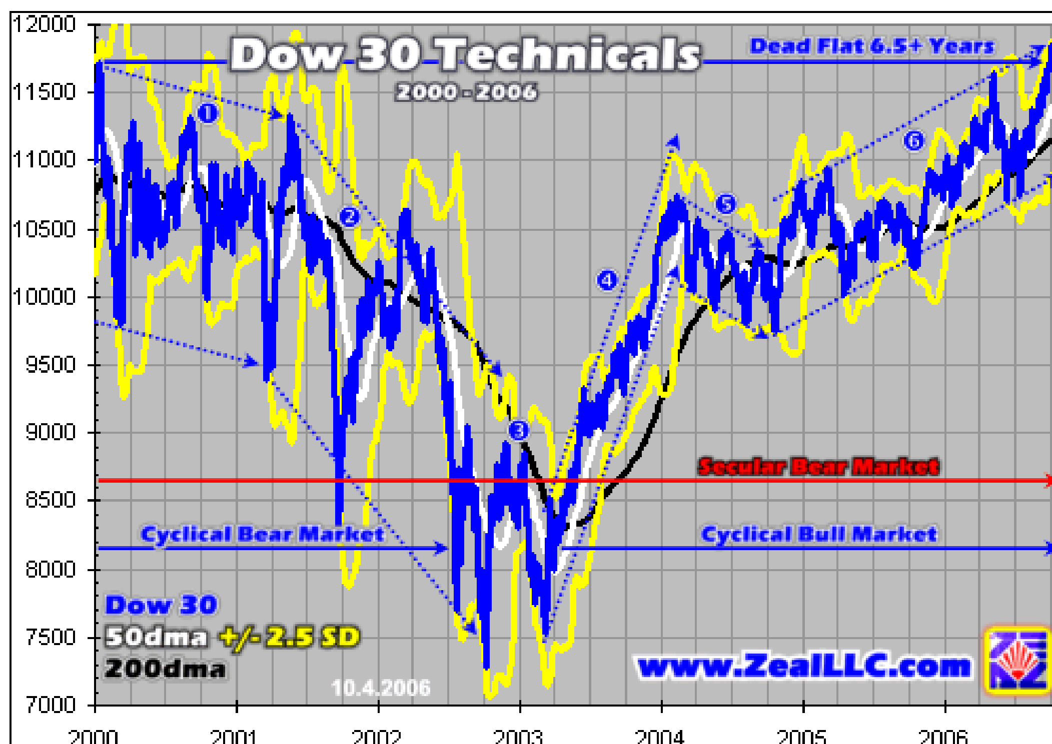
Back on January 14th, 2000, the mighty Dow 30 surged up to its previous all-time closing apex of 11723 after trading as high as 11909 during that day. Thus 11723 was watched with *great* anticipation over the last couple of weeks. Every day since Tuesday September 26th, the Dow teased the bulls by advancing over 11723 intraday only to fall back under this level by its close. On Thursday the 28th the Dow crept ever so near on close, 11718, but still failed.

But after the Dow's tantalizing flirting had whipped anticipation into a fevered pitch, this flagship blue-chip index finally consummated its record-breaking act on Tuesday the 3rd. After climbing to 11794 intraday, the index managed to settle at 11727 on close. The financial media were *ecstatic* and trumpeted the new all-time closing Dow 30 high with great fanfare. The implied message by the hyper-enthusiastic coverage was that the bull is back! Individual investors interviewed could barely contain their excitement.

But is the bull *really* back? After watching the financial media hype the new Dow record for the past couple of weeks, it was readily apparent that the event was not being analyzed objectively. Instead an incredibly one-sided view was being presented that used the new Dow record as an instrument of propaganda. Coverage was carefully crafted to convince nervous American investors that all is well in the markets.

Since the financial media has no problem telling us how incredibly bullish the new Dow 30 record is, I would like to present counterpoint arguments in this essay. As a lifelong student of the markets I strive to study and understand the markets within their long-term context, and quite frankly these new Dow 30 highs are neutral at best. They are certainly not bullish and may even prove to be quite bearish. Why? Read on.

While the phrase "record highs" certainly sounds exciting, the new Dow records must be considered within their *true strategic context*. As this first chart shows, all the new record highs have done for the Dow is dig it out of its very deep hole. Until this week, the Dow 30 investors had been down for over *six and a half years!* Now they are just dead flat in nominal terms since January 2000, really not very impressive.



Remember the wild media frenzy surrounding the stock-market mania in early 2000? Back then nearly everyone assumed that stocks

would continue to soar, that Dow 15000 couldn't be far away. I would argue that there has never been a time in the last few decades when stocks were so heavily hyped as during early 2000 when the Dow made its last *highs*. Countless investors were caught up in the mania and bought stocks near the very top of their multi-decade secular bull, goaded on *by the media*.

Yet if an investor had heeded the media's buy, buy, buy advice, he would only now be *breaking even* over six and a half years later. Despite this week's records, the Dow is now *dead flat* since January 2000. Now perma-bulls would argue that this isn't quite the case due to dividends. If Dow 30 dividends are compounded annually since January 2000, they yield a 13.4% gain. So in reality a blue-chip investor today who has held strong without selling since early 2000 is up 13.4% if he reinvested his dividends.

A 13.4% absolute gain over *almost seven years* is really horrible though. It has an enormous opportunity cost since investors could have earned vastly better returns elsewhere. For example, if an investor could have earned 4% annually in safe US Treasuries, he would be up 30.3% by now. And this risk-free gain would have created vastly less stress since the Treasuries would not have plunged in value like the Dow did in 2002.

There have been far better alternatives than bonds though. After writing in the summer of 2000 that a major general-stock bear market loomed ahead, I have been investing and speculating in the new commodities bull that was already becoming apparent to astute observers even way back then. Since the Dow's last record high in January 2000, commodities and companies that produce them have literally soared.

By believing the media hype in early 2000 that overvalued blue chips were *the* place for long-term investors to be, they missed staggering gains in the real bull market in commodities. *To the very day* between the first Dow 11723 close back then and the latest this week, gold is up 103.5%, the HUI gold-stock index up 316.2%, oil up 109.3%, and the XOI oil-stock index up 110.3%. The Dow 30's paltry 13.4% of reinvested dividends pales in comparison to the mighty gains won in commodities!

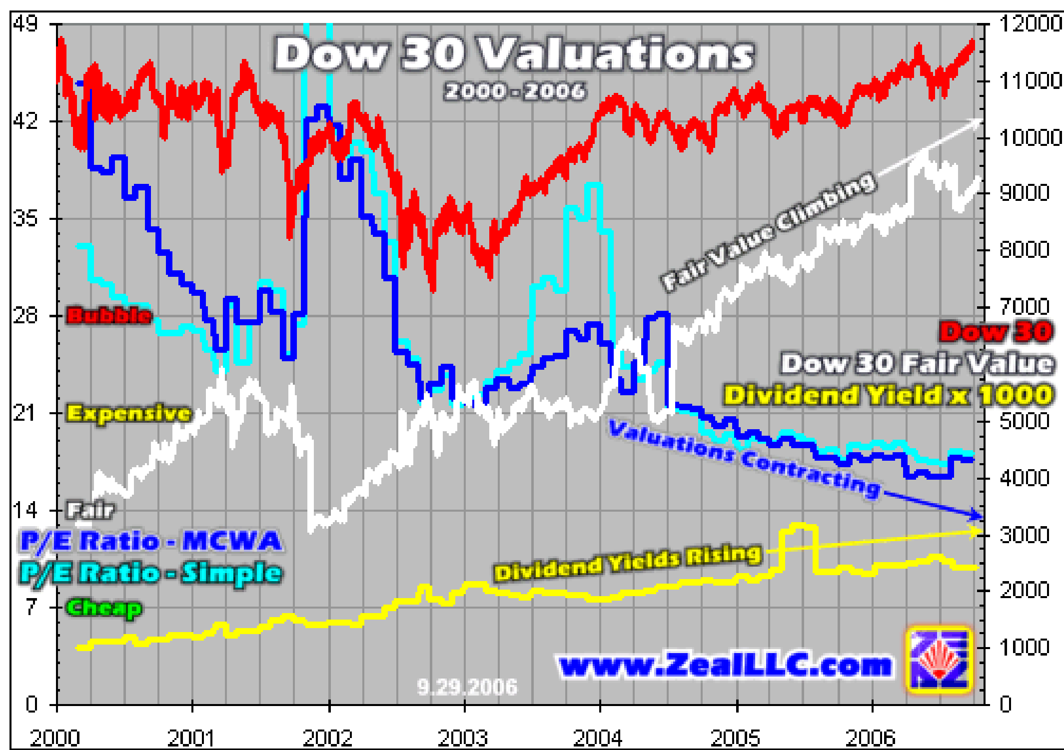
And in true purchasing-power terms, even if they did reinvest their dividends blue-chip investors *still lost* after inflation. The CPI inflation rate compounded annually since the original Dow records of January 2000 is running at 20.1%. So by merely holding Dow 30 stocks since then and even being brave enough not to sell during the very ugly bear-market plunges in 2001, 2002, and 2003, all an investor has to show for it today is a *6.7% real loss.* The most-favorable-possible light in which to view the past seven years of Dow action shows a loss.

As this chart clearly shows, the Dow and the general stock markets have been in a *secular bear market* since early 2000. While the Dow has had a half-dozen or so different tactical subtrends including a cyclical bear and a cyclical bull, its overall strategic action has been bearish. All this elite flagship blue-chip index has done in the last seven years is dig a big hole it is finally trying to claw out of. To be flat after nearly seven years is a major failure, so it is pretty misleading when the financial media is trumpeting this event as a huge success.

The reason the Dow 30 has been in a secular bear market since 2000 is the extreme valuations reached at the end of the previous secular bull of the 1980s and 1990s. The markets move in great valuation waves, slowly oscillating from undervalued periods to overvalued periods and back again over wavelengths running a third of a century or so each. The last wave crest was in 2000 and the valuation wave has been receding ever since.

The current Dow valuation wave reversion is readily apparent in the chart below. The blue lines show the Dow 30's price-to-earnings ratio, the most important measure of valuation. The yellow dividend yield line shows another important valuation measure. The actual Dow 30 is graphed in red while the hypothetical level of the Dow if it had been trading at its historical fair value of 14x earnings is charted in white.

This chart, unfortunately, is bad news for bulls and bears alike. The bulls want a major rally into a new bull and the bears want a sharp crash into a renewed bear. But this chart suggests that neither camp is likely going to get what it wants, that the Dow will just keep grinding sideways on balance as it has since 2000. The Dow is not making progress because it is waiting for its earnings to catch up with its high stock prices.



Back in early 2000 the Dow 30 was trading above 40x earnings the last time it meandered above 11700. This week it is trading under 18x earnings. This shows great progress as the Dow is *far* less overvalued now than it was back in January 2000. Some astute bulls are heralding today's *relatively* low valuations as evidence that the Dow is on the verge of a new bull market this time around.

Unfortunately though this is not the way valuation waves work. A complete 33-year valuation-wave cycle takes the Dow from undervalued levels to overvalued levels *and back again*. The undervalued component of this cycle happened back in 1982, when the Dow was trading under 7x earnings. The overvalued top was about 17 years later in late 1999 and early 2000 when the Dow was trading over 44x earnings. The next undervalued secular bottom will also almost certainly occur near or under 7x earnings again as they all do in history.

If this concept is new to you, I strongly encourage you to read an essay I wrote on it called "Long Valuation Waves 2". If you want to make money as a stock investor you *must* understand these valuation waves or you will not be successful over the long term. While today's Dow trading under 18x earnings is a vast improvement from the January 2000 valuations, the index still has a long ways to go yet until it gets back down near 7x earnings.

Valuation wave reversions typically last about *seventeen years* each! But so far the Dow is only about seven years into its own reversion. At this stage in the valuation waves, the next secular bullish point is not fair value around 14x earnings but deeply undervalued levels near 7x like we saw back in 1982. Thus it is not a valid argument by the bulls to use today's less-overvalued levels as evidence a secular bottom is near. During this stage of valuation waves the valuations overshoot to the downside just like they overshoot to the upside at their secular tops.

So if the bulls shouldn't be getting excited, then maybe the bears should, right? Not necessarily. A lot of hardcore bears are looking for a *crash* today due to a wide variety of economic problems in the US and the world. The problem is true crashes only occur off of major valuation tops such as in 1929 or early 2000. While bears can hope for a gradual cyclical bear market that takes a year or two, odds are they are not going to see massive daily declines but a slow grind lower.

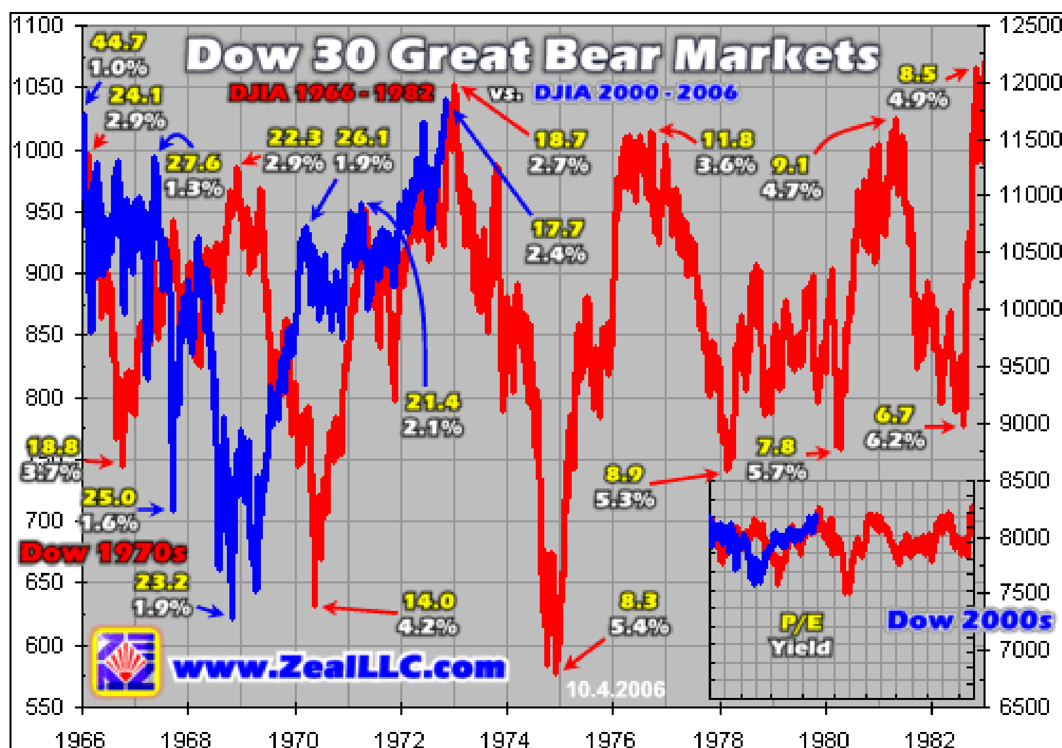
While the next chart gets into these slow grinds, there is one more aspect of the chart above worthy of consideration. The white line is where the Dow 30 would be trading if it was fairly valued at 14x earnings. Back in early 2000 this was well under 4000 but today it is over 9000. This means that corporate earnings have made a lot of progress in the last seven years in catching up with their high stock prices.

But once again at secular valuation bottoms the Dow is most likely to trade down to *half* fair value, around 7x earnings. So if you took the white line and halved it, that is the level where the Dow would have to fall to today to end its secular bear. But these cycles do not happen overnight, they tend to run seventeen years. So odds are the Dow 30 is going to continue grinding sideways on balance in a great trading range for the next *decade* or so. Ouch.

How can I make such a ridiculous assertion? Historical precedent demands it. The last time the Dow 30 was in a valuation wave reversion was from 1966 to 1982. Over that seventeen-year period the Dow tried to break decisively above 1000 no fewer than a half-dozen times but failed *every time*. The great bear back then led to a massive sideways trading range that kept Dow levels from materially exceeding previous highs long enough for earnings to catch up with stock prices.

Unfortunately today we are trapped in a long trading range again. The chart below highlights this lamentable conclusion. The Dow 30 since 2000 is charted in blue and superimposed over the Dow 30 of 1966 to 1982, the last time the stock markets were in *this phase* of

their long valuation cycle. The behavior of the last seven years, timing of the cyclical bulls and bears within the secular trend, and the valuations of today stack up uncannily well with those of the last Dow 30 great bear market.



Lest you wonder if this chart is visual sleight of hand created by manipulating the axes, it is not. The small inset chart at the lower right shows the same data with zeroed axes. The horrible and inescapable conclusion is the Dow 30 has behaved the same way in the past seven years as it did during the first seven years of its last great bear! It has traded sideways in a great trading range giving earnings time to catch up with stock prices to reduce valuations.

Since this chart makes me want to cry, I won't waste too much time discussing it here. I have talked about it in depth in my "Curse of the Trading Range" series of essays. But the core point is that the Dow 30 is likely to be still languishing around today's 12000ish levels *at best* for the *next ten years*. If you are not ready for this eventuality, it could prove catastrophic.

After all, if the average individual's useful investing lifespan only runs 40 years or so from the ages of 25 to 65, then spending one quarter of this time experiencing flat nominal returns and negative real returns would be devastating. We all only have a finite amount of time in which to accumulate wealth during our lifetimes and none of us can afford to be mired in an investment that is not likely to do much in the next *decade*. I sure hope this analysis is wrong, but markets have traded sideways for seventeen years during great bears many times before in history.

Tactically this comparison is especially relevant this week. Note that today's blue Dow is surging to a new record *at about the same time* in its secular bear as its predecessor did back in late 1972. Back then the Dow briefly hit new records over 1050 years into a cyclical bull. Today the same thing is happening. We are years into a *cyclical* bull hitting new record highs that are not much better than those achieved at the top of the last *secular* bull seven years earlier.

But when this same type of event happened in late 1972, it marked the end of the cyclical bull. The Dow briefly achieved a record high and then started grinding lower in a brutal cyclical bear that saw it lose about 45% of its value in 1973 and 1974. We could very well be on the verge of a similar ugly cyclical bear unfolding within our long secular bear trading range. If the Dow hits 12000 this time around before rolling over, an analogous 45% loss would drag it down under 7000 within two years!

Another uncanny similarity between this week's new Dow records and those of late 1972 is the valuation levels. Back then the Dow was trading at 18.7x earnings and yielding 2.7% in dividends. While this is not terribly overvalued, it is not undervalued either and at this stage in the valuation wave cycle valuations continue to relentlessly contract. Today the Dow is trading at *nearly the same valuations*, 17.7x earnings and yielding 2.4% in dividends! Talk about an overly ominous déjà vu!

Will it really happen again? I don't know, but it really could based on recent historical precedent of long trading ranges within great bear markets. And if it does, even bears should not get too excited. The 1973 and 1974 cyclical bear market was a ghastly slow-grinding affair. It took *two years* to run its course and did not offer a lot of really sharp daily declines like the bears like to see. A two-year downward spiral *slowly* unfolding is really not a good environment for anyone, long or short. There are no quick gains to be won on either side.

I've said it before and I'll say it again, I *hate* long secular trading ranges. Prices moving sideways for seventeen years are the *worst possible* environment. Since I only have a finite amount of years to multiply my own capital, I far prefer steep and fast bears such as the 1929 to 1932 episode over long and slow secular bears like the 1966 to 1982 specimen. Yet, unfortunately today we find ourselves in the latter grind.

Since the prospects for the Dow in the next decade continue to look so poor despite this week's records, I am avoiding it entirely. Thankfully during these great bear periods in the general stock markets commodities tend to thrive. Since it launched in 2001, the Great Commodities Bull of the 00's has yielded *tremendous* gains for investors and speculators. And fortuitously these commodities bulls tend to run for the same seventeen years in duration as the secular stock bears.

Thus my master plan is to earn a fortune in commodities-related investing in the next decade and then sell out and plow it all into general stocks when the Dow is trading near 7x earnings about ten years from now. By then elite blue-chip general stocks will be at bargain levels only seen three times a century and the next secular stock bull will be ready to launch, just like back in 1982. Until then though, I am multiplying my wealth in the young commodities bull.

If you are interested in investing and speculating in high-potential commodities stocks, the recent commodities weakness has created a stunning opportunity. The new Dow records are helping seduce capital out of commodities stocks temporarily leading to amazing bargain prices. We are buying elite producers aggressively at these lows and expecting enormous gains in the next major commodities upleg.

In fact our just-published October newsletter details *seven* incredible commodities stocks highly likely to explode heavenwards as soon as commodities start recovering. Subscribe today and you can still buy them at these fire-sale levels! *First-time* subscribers will receive a complimentary copy of this new October issue and your paid subscription will start with next month's issue.

The bottom line is the Dow 30's new record highs this week are not bullish despite the media hysteria to the contrary. The flagship blue-chip stock index is trading exactly as it should be deep within an ugly seventeen-year great bear market. We've seen nothing at all to challenge the thesis that this horrific long trading range remains intact.

The perma-bullish media was wrong that blue-chips were a great investment in early 2000 and I strongly believe they are wrong again today in advancing their new-bull thesis. Our current cyclical bull is long in the tooth and likely to roll over soon into a cyclical bear. The refuge of choice to avoid this coming carnage is in elite undervalued commodities stocks likely to thrive tremendously.

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