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EUROPEAN MARKET COMMENTARY

NEW BULL OR SAME OLD SECULAR BEAR?

August 2006

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New Bull or Same Old Secular Bear?

Since bottoming in early March 2003, the FTSE All-Share has climbed over 88% and is now only 8% below its "tech bubble" peak reached on September 4, 2000. The market has bulked up in size as well, with the market capitalization of the All-Share within 6% of its all-time high. Meanwhile, earnings have grown 128% over the same period, helping to drive the price-to-earnings (P/E) ratio from 17.8 to 13.3, its lowest level since June 1991, and below its historical average of 14.6 since 1963.

With the market on the verge of a full recovery, is the current run-up simply a strong cyclical rally amid the secular bear market that we (and many other observers) felt began in 2000, or do seemingly benign valuations signal that the market has purged itself of its previous excesses and is ready to embark on a renewed bull market? With financial markets nervous about inflation, interest rates, and economic growth, this seems an appropriate time to try to gauge where we stand today in relation to past market cycles.

Of Bulls and Bears

To put the current cycle in historical context, we tried to identify the major U.K. market cycles, both cyclical and secular, since the late 19th century. For our purposes, we have defined a "bear market" as a market decline of 20% or greater lasting longer than one month. Conversely, "bull markets" are defined as continuous periods of market advancement without a decline of 20%. Since 1887 we have identified 37 market cycles (19 bull markets and 18 bears), including the current rally beginning in 2003.

Among these numerous bull and bear markets we have tried to identify the major secular market moves of the past 120 years, in an attempt to differentiate shorter-term cyclical movements from "big picture" structural shifts in market direction. Admittedly, here is where the analysis becomes more art than science, with a pinch of subjectivity added to the quantitative recipe. In addition to broad market moves from peak to trough, we take into account market valuations and periods that, with the gift of hindsight, appear to be general turning points in market direction. With that said, we have identified five secular bull and five secular bear markets that fit our framework. Tables A through C summarize our findings.

So how does the current rally compare to history? Relative to all bull markets, the current rally seems to be running a bit slow, gaining 88.6% over 41 months, compared to the average advance of 109.9% over 48 months. Yet when put into the context of a cyclical rally in a secular bear market, the current rebound seems long in the tooth, with the average "bear market rally" gaining 69.0% over 18 months. Although the strength and duration of the current rally is well above average, it is not without precedent. A particularly ferocious cyclical rally in 1975 saw the All-Share rise 148.9% over six months before quickly resuming its downward path, while a 54-month cyclical rally from June 1932 to December 1936 saw the market rise 105.3% before turning down to eventually reach a new bear market low.

While the current rally has nearly returned the market to its previous peak, such a retesting of the previous high is not unheard of during secular bear markets, with the previous peak often acting as a long-term resistance level. For example, the secular bear market that began in 1929 saw the U.K. market fall 52.3% over 33 months before the 1932 rally brought it within 2.1% of its 1929 peak. A subsequent decline of over 52.3% quickly ensued, however, driving prices to their twentieth century nadir. Another such example took place during the sideways bear market of 1947-52, in which the market fell 25.1% from 1947-49, only to rally within 4.4% of its previous peak before abruptly falling to a fresh low in 1952.[1]

If we are to assume that the current rally signals the end of the "post-tech bubble" secular bear market, how does the most recent rout compare to history? From its peak in September 2000, the All-Share fell nearly 35% before staging a brief 22% rally between September and December of 2001, which was soon followed by a further decline of almost 40% over 15 months. By March 2003, the All-Share had fallen 51.2% top to bottom. If this indeed marks the end of the secular decline, at 30 months it would be the shortest on record (compared to the average duration of 126 months for the previous four secular bear markets), but second only to the post-1929 bear market in terms of severity. Yet given that the current bear market arguably follows the most amazing bull run in financial history (with the All-Share gaining over 2,700% from its lows in the late 1970s) and an unprecedented level of market overvaluation, we would expect the path down the other side of the mountain to be uncommonly steep also.

Furthermore, if the secular bear market came to an end in March 2003, it did so with an unprecedented valuation level for a market low. Tables B and C show valuations at bull market peaks and bear market troughs. The All-Share's P/E ratio of 17.8 near its March 2003 bottom is by far the largest such multiple for a secular bear market, and well above the average cyclical bear market trough P/E of 10.5. Indeed, a P/E ratio of 16 to 17 is closer to the average valuation at historical secular bull market peaks.

But is it Different this Time?

It rarely is, but relying solely on history occasionally leads one to be blind-sided when the future only slightly resembles the past. Those who argue that the current rally marks the end of the secular bear market take comfort in the fact that market P/E valuations have come down to levels last seen in 1991, when the All-Share was in the early stages of what became an amazing bull market.

Yet as we have discussed in past comments, current P/E ratios reflect peak levels of earnings, margins, and return on equity (ROE), and are thus obscuring the general level of overvaluation in the market.[2] As Table D shows, real normalized P/E and ROE-adjusted P/E ratios (which take into account earnings cyclicality) remain above their long-term averages and have actually been rising steadily since

[1] While the secular bear market from June 1947 to June 1952 is the mildest we have identified, with the market falling only 28.8% over five years, it represents an important milestone. The preceding bull market (1940-47) finally saw the U.K. market surpass its February 1900 peak, a level of resistance not even broached during the bull market of the "roaring" 1920s. As is often the case, the market was unable to maintain its newfound highs in 1947 and spent the next five years retreating from this key level. When the market bottomed in June 1952, share prices remained close to 13% below their level half a century earlier.

[2] Please see our March 2006 and May 2006 European Market Commentaries, *European Equities Getting Pricey* and *U.K. Equity Valuations: A Cross-Sectional Peek.*

2003. These metrics are also substantially higher than their 1991 levels, implying that the market is not as benignly positioned as 15 years ago.

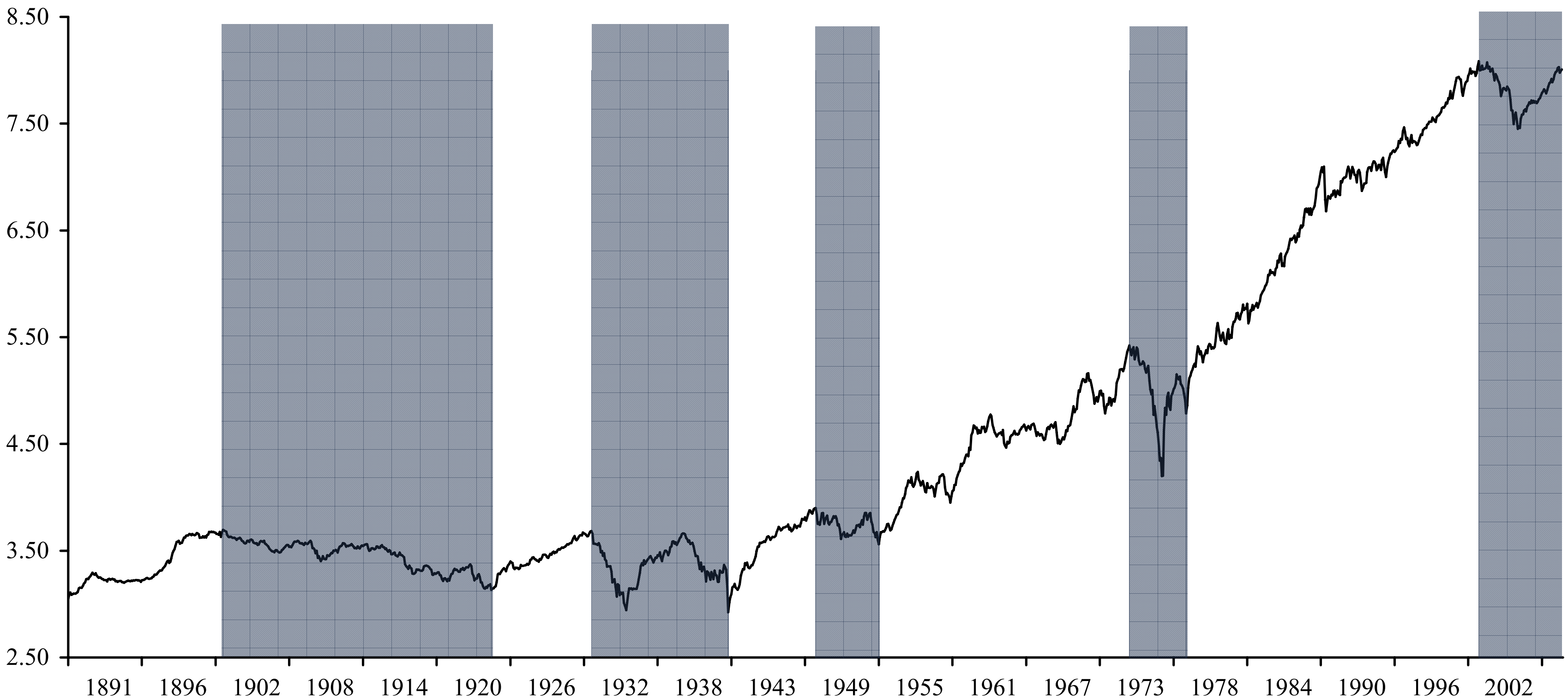
Importantly, today's P/E ratios implicitly assume that the current level of earnings can be can be sustained. With U.K. ROE running at 19.9%, more than 2 standard deviations above its long-term average of 14.0%, such assumptions about future profitability seem heroic. With the global economy possibly facing the major headwind of a U.S. economic slowdown coupled with the continued removal of accommodating monetary policies (which have helped underpin economic growth over the past few years), we feel that current valuations do not adequately discount the potential for slower earnings growth. With the U.K. market skewed toward energy, materials, and financial companies, all of which are particularly vulnerable to any deceleration in global growth, market expectations have substantial scope to disappoint.

While it may possibly be "different this time" with the earnings bonanza of the past three years representing a secular shift in corporate profits and ROE, this sounds more like the sort of leap of faith that commonly accompanies market tops. Our belief in cyclically high valuations and the headwinds facing earnings lead us to expect relatively weak market performance going forward, especially compared to the returns of the past three years. We would not be surprised if any strong market gains in the near future prove to be fleeting and are followed by equally stiff declines, or at best a range-trading market similar to those of the early 1950s and the mid-1960s.

Table A

HISTORICAL U.K. SECULAR BULL AND BEAR MARKETS

30 November 1887 - 31 July 2006



Sources: Global Financial Data, Inc. and Goldman Sachs.

Notes: Graph is in logarithmic scale. Shaded sections represents secular bear markets. Data represent historical U.K. stock market price index levels as compiled by Global Financial Data.

Table B

HISTORICAL U.K. BULL AND BEAR MARKETS

30 November 1887 - 31 July 2006

Cyclical Bear Markets

Peak	Trough	Peak Price Level	Trough Price Level	Price Decline (%)	Duration (Months)	Trough Price-Earnings Ratio	Trough Dividend Yield (%)
28-Feb-1900	31-Oct-1921	40.2	23.0	-42.9	260.1	---	---
30-Sep-1929	30-Jun-1932	39.8	19.0	-52.3	33.0	7.5	---
31-Dec-1936	31-Jul-1940	39.0	18.6	-52.3	43.0	7.4	---
30-Jun-1947	30-Jun-1949	49.4	37.0	-25.1	24.0	8.7	---
31-May-1951	30-Jun-1952	47.2	35.1	-25.5	13.0	6.0	---
31-Jul-1955	28-Feb-1958	69.2	52.0	-24.9	31.0	5.8	---
30-Apr-1961	31-Jul-1962	118.5	86.9	-26.7	15.0	10.5	---
31-Jan-1969	27-May-1970	181.0	114.3	-36.9	15.8	14.2	4.7
1-May-1972	13-Dec-1974	228.2	61.9	-72.9	31.4	4.0	12.1
6-Jun-1975	8-Aug-1975	154.1	122.3	-20.7	2.1	6.3	7.0
30-Jan-1976	27-Oct-1976	172.6	116.3	-32.6	8.9	8.1	7.2
4-May-1979	15-Nov-1979	283.8	219.9	-22.5	6.4	7.0	6.6
17-Aug-1981	28-Sep-1981	338.6	265.9	-21.5	1.4	9.5	5.5
16-Jul-1987	10-Nov-1987	1,238.6	784.8	-36.6	3.8	13.7	4.1
3-Jan-1990	24-Sep-1990	1,226.8	962.1	-21.6	8.7	10.6	5.1
20-Jul-1998	5-Oct-1998	2,885.2	2,166.1	-24.9	2.5	18.6	2.8
4-Sep-2000	21-Sep-2001	3,266.0	2,128.2	-34.8	12.6	20.7	2.6
6-Dec-2001	12-Mar-2003	2,595.9	1,593.3	-38.6	15.1	17.8	3.8
			Average	-34.1	29.3	10.4	5.6
			Median	-29.7	14.0	8.7	5.1

Table B (continued)

HISTORICAL U.K. BULL AND BEAR MARKETS

30 November 1887 - 31 July 2006

Cyclical Bull Markets

Trough	Peak	Trough Price Level	Peak Price Level	Price Rise (%)	Duration (Months)	Peak Price-Earnings Ratio	Peak Dividend Yield (%)
Nov-30-1887	28-Feb-1900	21.1	40.2	91.0	147.0	---	---
31-Oct-1921	30-Sep-1929	23.0	39.8	73.2	95.0	9.7	---
30-Jun-1932	31-Dec-1936	19.0	39.0	105.3	54.0	13.7	---
31-Jul-1940	30-Jun-1947	18.6	49.4	165.6	83.0	12.8	---
30-Jun-1949	31-May-1951	37.0	47.2	27.6	23.0	6.1	---
30-Jun-1952	31-Jul-1955	35.1	69.2	96.9	37.0	6.6	---
28-Feb-1958	30-Apr-1961	52.0	118.5	128.0	38.0	9.3	---
31-Jul-1962	31-Jan-1969	86.9	181.0	108.3	78.1	23.1	3.1
27-May-1970	1-May-1972	114.3	228.2	99.7	23.2	19.9	3.1
13-Dec-1974	6-Jun-1975	61.9	154.1	148.9	5.7	7.2	6.0
8-Aug-1975	30-Jan-1976	122.3	172.6	41.2	5.7	9.5	5.6
27-Oct-1976	4-May-1979	116.3	283.8	144.1	30.2	9.3	4.7
15-Nov-1979	17-Aug-1981	219.9	338.6	54.0	21.1	9.0	5.8
28-Sep-1981	16-Jul-1987	265.9	1,238.6	365.9	69.6	19.6	3.0
10-Nov-1987	3-Jan-1990	784.8	1,226.8	56.3	25.8	12.6	4.2
24-Sep-1990	20-Jul-1998	962.1	2,885.2	199.9	93.8	21.8	2.4
5-Oct-1998	4-Sep-2000	2,166.1	3,266.0	50.8	23.0	26.4	2.1
21-Sep-2001	6-Dec-2001	2,128.2	2,595.9	22.0	2.5	21.0	2.6
			Average	109.9	47.5	14.0	3.9
			Median	98.3	33.6	12.6	3.1
Current Rally							
12-Mar-2003	31-Jul-2006	1,593.3	3,004.3	88.6	40.6	13.3	3.0

Sources: FTSE International Limited, Global Financial Data, and Thomson Datastream.

Notes: Bear markets are defined as a market decline of 20.0% or greater lasting longer than one month. Periods calculated using monthly data from November 1887 through December 1968 and with daily data beginning 1 January 1969. Index valuations are based on Global Financial Data from (1927-64), the FTSE Total Non-Financial (1965-92), and the FTSE All-Share (1993-2006). Index valuations data are annual for the period 1927-61 and monthly from 1962-2006.

Table C

HISTORICAL U.K. SECULAR BULL AND BEAR MARKETS

30 November 1887 - 31 July 2006

Secular Bear Markets

Peak	Trough	Peak Price Level	Trough Price Level	Price Decline (%)	Duration (Months)	Trough Price-Earnings Ratio	Trough Dividend Yield (%)
28-Feb-1900	31-Oct-1921	40.2	23.0	-42.9	260.1	---	---
30-Sep-1929	31-Jul-1940	39.8	18.6	-53.3	130.0	7.4	---
30-Jun-1947	30-Jun-1952	49.4	35.1	-28.8	60.0	6.0	---
1-May-1972	27-Oct-1976	228.2	116.3	-49.0	53.9	8.1	7.2
			Average	-43.5	126.0	7.2	7.2
			Median	-46.0	95.0	7.4	7.2
"Tech-Bubble" Bear Market							
4-Sep-2000	12-Mar-2003	3,266.0	1,593.3	-51.2	30.2	17.8	3.8

Secular Bull Markets

Trough	Peak	Trough Price Level	Peak Price Level	Price Rise (%)	Duration (Months)	Peak Price-Earnings Ratio	Peak Dividend Yield (%)
Nov-30-1887	28-Feb-1900	21.1	40.2	91.0	147.0	---	---
31-Oct-1921	30-Sep-1929	23.0	39.8	73.2	95.0	9.7	---
31-Jul-1940	30-Jun-1947	18.6	49.4	165.6	83.0	12.8	---
30-Jun-1952	1-May-1972	35.1	228.2	549.2	238.0	19.9	3.1
27-Oct-1976	4-Sep-2000	116.3	3,266.0	2,708.5	286.3	26.4	2.1
			Average	717.5	169.8	17.2	2.6
			Median	165.6	147.0	16.4	2.6

Current Market Rally

Trough	Peak	Trough Price Level	Peak Price Level	Price Rise (%)	Duration (Months)	Peak Price-Earnings Ratio	Peak Dividend Yield (%)
12-Mar-2003	31-Jul-2006	1,593.3	3,004.3	88.6	40.6	13.3	3.0

Sources: FTSE International Limited, Global Financial Data, and Thomson Datastream.

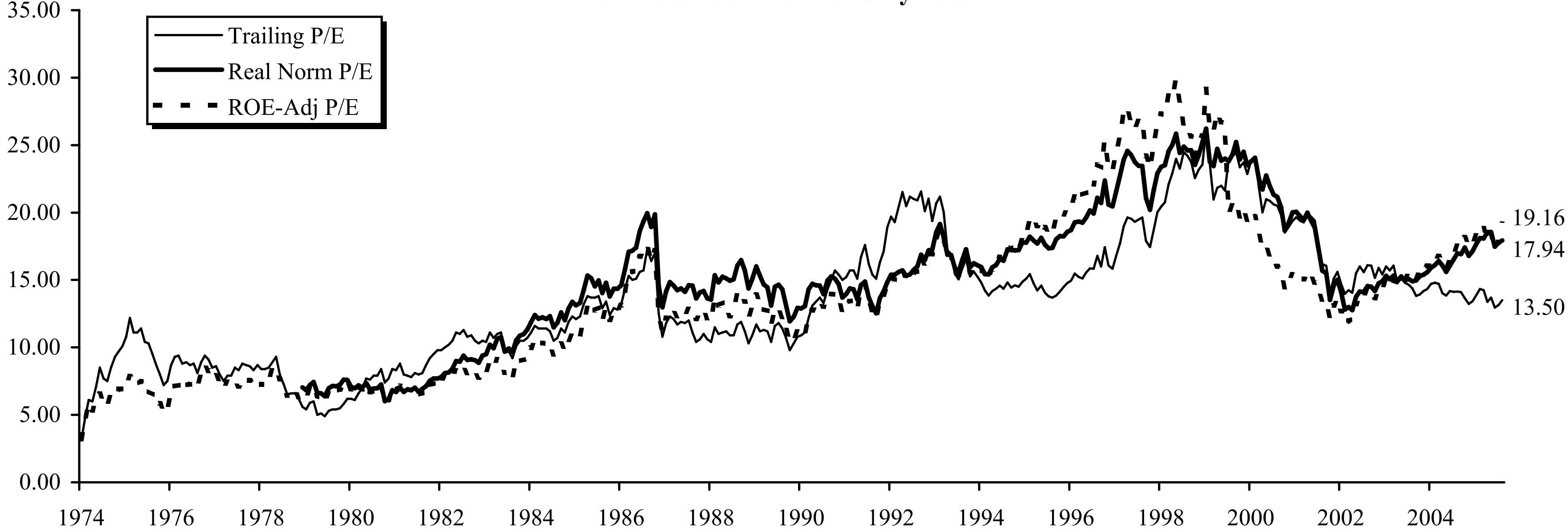
Notes: Periods calculated using monthly price index data from November 1887 through December 1968 and with daily data beginning 1 January 1969. Index valuations are based on Global Financial Data from (1927-64), the FTSE Total Non-Financial (1965-92), and the FTSE All-Share (1993-2006). Index valuations data are annual for the period 1927-61 and monthly from 1962-2006.

Table D

PRICE-EARNINGS RATIOS USING VARIOUS EARNINGS DEFINITIONS

MSCI United Kingdom

31 December 1974 - 31 July 2006



P/E Ratios - By Types of Earnings

	Trailing 12 Months Reported	Trailing 10 Years Real Normalized	ROE-Adjusted
July 31, 2006	13.50	17.94	19.16
Common Period Mean	14.37	15.39	14.78
Std Dev Above/Below Mean	-0.19	0.52	0.79

Sources: Morgan Stanley Capital International and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Normalized real price-earnings ratios are calculated by dividing the current real index value by the annualized average real earnings for the trailing ten years. U.K. inflation data represents the Retail Price Index from 1974 through November 2003 and the U.K. CPI from December 2003 onward. Inflation data are through 31 May 2006. Return on equity is calculated by dividing the index's price-book ratio by its price-earnings ratio. The ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to its post-1974 average. Common period represents data from November 1979 onward.

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