

Napier, Russell – Anatomy of the Bear

Harriman House, 2009 3rd ed, [Finance] Grade ★★★★★

This is a study of the four best moments to buy American stocks in history, namely 1921, 1932, 1949 and 1982. These occasions were followed by long secular bull markets. At all these buying opportunities the valuation was low, but how do you know when the market is cheap enough and won't continue down to become even cheaper? How do you time the troughs? Russell Napier, previously the Asian equity strategist at the Chinese investment bank CSLA and a manager of both American, Japanese and Asian equity portfolios, tries to answer this question by reviewing 70.000 articles in the Wall Street Journal during the months' adjacent to the four market bottoms.

The author mixes the studies of the bottoms with descriptions of both the equity and the bond market as they developed the years before the troughs. Combined this gives the reader an exposé of the American financial markets from the 1890's to the 1980's. There are numerous experiences to be drawn that aren't strictly tied to timing the bottoms. One is that media headlines don't seem to be all negative at the time of the buying opportunities. Even in 1932 the news was rather more mixed but investors choose to ignore the light in the tunnel.

Another aspect is the longevity of the bear markets that precedes the buying opportunities. Napier finds it unfortunate that the crash of 1929/32 has become the epitome of how an overvaluation in three years by a dramatic fall of 89 per cent is turned into an undervaluation. The more normal rote to undervaluation is rather a 14 year long consolidation period during which the stock market goes nowhere or slightly down, but the corporate earnings continue to grow. Further, the bear markets often coincided with serious disturbances in the general price level, like the high inflation of the 1970/80's, the inflation turning to deflation 1921 and 1949 and the severe deflation of 1932.

All and all this is a very useful read. There is plenty written about the big bubbles and how they pop, but you never read that much about the most important troughs. The historical perspective is important for anyone trying to understand the present and it's a sympathetically written text but at times I found it to be somewhat cumbersome. Also it's not easy to get a comprehensive picture of a course of events from a number of cuts from news articles.

So how do you time the troughs? For a start the market must be really cheap. Measured by the so called q, the corporate capital of America traded on 30 per cent of replacement value and the Shiller-PE was between 4,7 and 11,7. In four out of four troughs there was a stabilization of commodity prices and especially a rising copper price worked as a good indicator. Also look for confirmation of the sustainability of the price rise from low inventory levels. The economy and the stock market on average turned up simultaneously and even if this was apparent only in retrospect one consistent sign that this was the case was that a rise in auto stocks preceded the general stock market. Prices in government bonds in these instances turned much too early to be a good indicator but corporate bonds worked as a much timelier indicator where prices stabilized a few months ahead of the buying opportunities in stocks. On top of that, the Dow Theory worked. What didn't work was to wait for a turn of corporate profits or an improvement of the fiscal situation. Those improved much too late.

You really must question the use of listening to economic commentators after reading this book. At every bottom there were numerous persons with both positive and negative arguments, both equally persuasive and presenting argument you could have heard almost anytime on Wall Street the last ten or twenty years.

Mats Larsson, November 3, 2012