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US large-cap stocks are bargains of a lifetime

By Bill Miller
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The common view seems to be that the weak stock market reflects a weakening economy.

But we think the converse is more likely: the weak stock market is causing the economy to weaken. It is not a surprise that the recent US consumer confidence numbers were so poor; with the stock market having fallen so sharply since late April, they could hardly be otherwise.

Using the outlook for the economy to predict the direction of the stock market, which most appear to do, is to look at things the wrong way round. The stock market's behaviour will predict the economy's future behaviour. The market's decline since late April foreshadowed the soft economic numbers now being reported, just as the market's rally beginning in the spring of 2009 foretold the beginning of the recovery now under way.

Markets are all about expectations and the critical question for investors is always, what is discounted? Are the expectations reflected in market prices too high, or too low? One clue is to look at financial stocks. Financials tend to lead the market, both on the upside and the downside.

They have been market leaders off the bottom in March 2009, and they peaked in 2007 well before the market. They peaked about two weeks before the market in April and have led it down in this correction.

If financials begin to act better, the market should follow; and if they languish, then the market is likely to do no better.

Financials in particular and the market in general, have been plagued with a variety of worries since April, when concerns about the Greek financial situation led to a more generalised worry about sovereign debt. The BP oil spill, Goldman Sachs coming under fire from the Securities and Exchange Commission, gold's relentless rise, the shape of the financial reform bill, the spectre of higher taxes as the Bush tax cuts expire, all weighed on the market during this swoon.

To say that they caused the market drop, though, is a stretch. "What will the stock market do, Mr Morgan?" someone asked JPMorgan over a hundred years ago. "Fluctuate," he is said to have replied. That's what markets do, and in late April after eight straight weeks higher, the string was broken. The news is always a mix of positive and negative. When markets decline, people point to the negative news; and when it increases, the positive news is emphasised.

This decline has led to elevated levels of bearish sentiment, and bearish activities, such as rising put call ratios, which is probably setting the stage for a rally. I hope so. But hope is not a strategy, as the saying goes.

Having a long-term strategy may seem quaint in a market dominated by high frequency trading, the 24-hour news cycle, the ubiquitous and shrill blogosphere, flash crashes, and where it is repeated as if divinely given that buy and hold is dead.

The summer of 2010, though, when most global markets are down, pessimism about the future is high, and macro concerns predominate, is one of those rare periods where one can reliably adopt a long-term strategy that promises (but of course cannot guarantee) returns superior to what just about everybody else is now doing.

The public's distaste for equities is palpable and understandable. Negative returns for 10 years in stocks while "riskless" Treasuries have soared, and right after one of the best six months Treasuries have had in the decade, is more than enough to convince folks that stocks are not good long-term investments.

Then there is the really long term. Long-term Treasuries, as measured by the Barclays Capital Long Term Treasury Bond total return index, have beaten equities as measured by the S&P 500 in the year to date, and in the 3-, 5-, 10-, 15-, and 20-year time frames. It's a tie at 25 years. More than 20 years of superior returns over stocks in an asset guaranteed by the US government seems to be sufficient to drive a stake through the heart of the idea that you want stocks for the long term.

It's a truism in capital markets that the best investments are those that have previously done worst, where expectations are low, demand is down, and prospects appear at best highly uncertain. In 1980, bonds had been through a 30-year bear market relative to stocks, inflation was soaring, yields were at historic highs, yet expected to go higher, and a long bull market in bonds was at hand.

The idea that US interest rates would be near all-time lows 30 years later would have been dismissed as ludicrous. The situation is now reversed, with stocks having underperformed bonds for decades.

The point here is simple: US large capitalisation stocks represent a once-in-a-lifetime opportunity in my opinion to buy the best quality companies in the world at bargain prices. The last time they were this cheap relative to bonds was 1951. I was one year old then, but did not have sufficient sentience to invest. I do now, and if you are reading this, so do you.

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