## A Crash in Late 2014?

By Kerry Pechter Tue, Dec 24, 2013
"We can guess at a market peak sometime between Sept. 2014 and June 2015, at a level much higher than the current one. We can, however, be pretty sure that once the market has peaked, its fall will be both prolonged and steep," writes the author of the Prudent Bear blog.

One year ago, in a year-end column for 2012, I predicted that the easy-money bubble would continue inflating through 2013, which should be a good year for asset prices, but that 2014 would be more problematic.

Having been "right so far" with this prediction, I thought it worth re-examining to determine whether the crash will indeed occur in 2014, as I then predicted, or whether investors may be able to enjoy another good year before doom hits. My crystal ball is more clouded than it was a year ago, and the first half of 2014 looks good, but I wouldn't be too certain about the fourth quarter.

I was certainly right to be pretty optimistic for 2013. The Standard \& Poor's 500 Index is up today 25\% from Dec. 31, 2012, and the Dow Jones Industrial Average is up $21 \%$. On the other hand, the MSCI World Ex. U.S. Index is up only a more modest $12 \%$ and gold is sharply down, by about $26 \%$.

I confess an expensive error in the last area - it seemed to me (and still seems) that with Japan having joined most Western economies in mad monetary stimulus, gold had to rise sharply-indeed I suggested a price of $\$ 3,000$ an ounce. Instead, all the money seems to have gone into Bitcoin-a sad commentary on the downfall of solid values in modern life. Still, overall, I was right for 2013 and am tempted to repeat the prognostication for next year.

Well, let's have a look, shall we? If next year is an exact replica of this year, the S\&P 500 Index will end at 2,224 and the Dow Jones Industrial Average will end the year at 19,232. Gold, on the other hand, will end the year at \$912. Hmm.

I have to say that combination looks pretty unlikely. I could indeed see gold at $\$ 912$, which would imply that monetary stimulus had been scaled back and that the inflationary psychology had been eliminated from the markets-including those in India and China from where the majority of today's incremental demand for gold arises. Perhaps we would have had some actual deflation in the West, with prices declining, thus removing gold's psychological advantage as an inflation hedge.

In that case, real interest rates would have risen, since at least long-term rates can't fall below zero. Corporate profits would surely have fallen and much of the bubble psychology would have been wrung out of the stock market. In other words, the S\&P 500 Index would most likely be chasing the gold price down toward 900.

Conversely, to get the S\&P 500 index up to 2,224 , corporate profits would have to show considerable further oomph beyond today's level, which is already an all-time high in terms of U.S. Gross Domestic

Product. To get profit margins rising like that money would still have to be very cheap and inflation would have to have ticked up a bit. In that case, gold would surely be chasing the S\&P 500 Index up beyond \$2,200.

In other words, 2014 can't be like 2013. It will therefore have to be different. Polish the old crystal ball, and let's estimate in which direction the differences might arise.

One factor that should make us bearish is that everyone else is bullish. The top-ten Wall Street banks, polled by Marketwatch, all think the market will be higher at the end of 2014 than it is today. They forecast rises in the S\&P 500 Index ranging from $4 \%$ to $17 \%$-all of them short of the "naïve" forecast of $25 \%$, let it be noted. That's not definitive. You could get a net rise of $10 \%$ on the year with a market that rose $50 \%$ and then turned round and fell $27 \%$, in which case the net $10 \%$ rise would pretty clearly be the harbinger of dark days ahead in 2015.

However, the overall optimism of Wall Street pundits does suggest that most of the buyers are in the market already, which you'd expect in a market up $25 \%$. Those who were out-or who like me bet on the sectors of precious metals and emerging markets that have performed worst this year-have to feel pretty stupid right now.

Ben Bernanke's decision last week to reduce the amount of bond purchases undertaken by the Fed is bullish for the long term-at least as it avoids one form of catastrophic risk-but it clouds the picture in the short term, although the market's initial reaction was euphoric.

According to Bernanke, we can expect a gradual further decrease in bond purchases, perhaps with a $\$ 10$ billion decline at each Fed meeting in 2014 so that by the end of the year purchases would have halted altogether and the Fed balance sheet would have stabilized at $\$ 4.5$ trillion. That's a much more tolerable situation than we would have been facing if Bernanke hadn't tapered: expanding the Fed's balance sheet until it swallowed the U.S. economy.

The global economy is nowhere near capacity, which leads me to suspect a further lengthy period of recovery before the next recession hits. You'd expect recovery to continue fairly slowly in the rich Western countries, as wages continue equalizing between the West and emerging markets.

On the other hand, there seems no reason why Africa should not continue to get rich rapidly. Indeed, while Chinese growth has slowed and India, Brazil and Russia have all in their different ways run into problems, sub-Saharan Africa is so much poorer than other emerging markets (at around \$1,400 per capita GDP compared with $\$ 9,600$ in Latin America) that it should have a decade or so of rapid growth ahead before the inevitable constraints of its poor government and infrastructure really begin to bind.

Nevertheless, between the two extremes of an early crash and a stock-market boom that goes on and on, there seems to be a likely outlook somewhere in the middle. At the extreme case, it would seem very unlikely that the current market boom can last until the end of 2015, even if the Fed does indeed hold short-term interest rates near zero for the whole period.

For one thing, long-term interest rates have risen substantially in spite of the $\$ 85$ billion of monthly bond purchases. So reduction of the pace of bond purchases should cause the rise in rates to continue, or otherwise accelerate. In the long run, that has to cause a market decline as corporate profits will be affected.

At the other extreme, the Fed still will be purchasing $\$ 50$ billion or more of bonds monthly until the middle of next year, which should limit the rise in long-term rates in the next six months. Only when Fed purchases taper toward zero, in the second half of 2014, does the current market euphoria seem likely to lessen.

In the meantime the market will have gone much higher-it is rising at far more than the average market prediction of $10 \%$ a year-because of the flood of money into it, and should continue doing so.

On balance, therefore, we can guess at a market peak sometime between Sept. 2014 and June 2015, at a level much higher than the current one. We can, however, be pretty sure that once the market has peaked, its fall will be both prolonged and steep. Long-term interest rates will rise, so corporate profits will decline. The mass of malinvestment caused by the last five years of zero short-term interest rates will be a massive overhang on the market.

The outlook for investors is thus difficult. The opportunity to make money will extend for only a few more months, after which there will be a period, possibly as long as 3-4 years, during which any foray into the market will be rewarded by massive losses. Sell too early and you could miss not just the last $10 \%$ of the run-up, but the last $30-40 \%$ if it extends into 2015 . Sell too late and your invested capital will spiral into the abyss.

In any case, bears can be comforted by one thing: the higher the market climbs, the harder it will fall. © 2013 Prudent Bear, Martin Hutchinson.

