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"The line separating investment and speculation, which is never bright and clear, becomes blurred still further when most market participants have recently enjoyed triumphs."
-WARREN BUFFETT

Why is it that bull markets take on a life of their own, often rising much more than fundamentals dictate? While there are multiple answers to that multi-trillion-dollar question, one of them is clearly, in my opinion, time. The longer bull markets run, the more invincible they appear. Warnings of a correction become methodically discredited, as prices march relentlessly higher (I know of what I speak, not just this go-round but in 1999 and 2007, as well).

Horsesmouth.com is an investment news service to which I've subscribed for well over a decade. And, it's a rare day when I can't find an article in its daily recap of a dozen or so pieces that is unusually interesting. One of its regular contributors, and a frequent source of valuable technical insights, is veteran market observer Walter Deemer.

Last week, Walter wrote one of his most important essays, in my view, especially given where we are in the current market cycle. As you will soon read, time plays a very important role as there has been a pronounced tendency for bull markets to run out of steam at the four-year mark. Occasionally though, they manage to "extend" and due to the market run's long-lasting nature, the public, which is invariably highly skeptical at first, gets sucked in when the festivities are winding down.

Another key factor in extended bull markets is liquidity. As you will see, excess liquidity has been a recurring force behind all of the prior past-their-sell-by-date bull episodes. Of course, we are currently experiencing the mother of all liquidity-powered bull markets, thanks to the Fed's multi-trillion-dollar money dump.

Also, it's important to realize, based on past precedent, that this bull can definitely keep running. Past *EVA*s have noted the distinct possibility of an upside blow off, which would almost certainly draw even more unsophisticated and performance-chasing participants (like the millions of retail investors who couldn't resist the lure of easy gains in 1999). But the sobering message about this scenario is that the more—and longer—these phases go, the harsher the eventual "mean reversion" becomes.

As a final lead-in to this week's guest *EVA*, I thought this Warren Buffett quotation, found by Evergreen's ever-diligent Jeff Eulberg, was the perfect segue:

"Nothing sedates rationality like large doses of effortless money. After a heady experience of that kind, normally sensible people drift into behavior akin to that of Cinderella at the ball. They know that overstaying the festivities—that is, continuing to speculate in companies that have gigantic valuations relative to the cash they are likely to generate in the future—will eventually bring on pumpkins and mice. But they nevertheless hate to miss a single minute of what is one helluva party. Therefore, the giddy participants all plan to leave just seconds before midnight. There's a problem, though: They are dancing in a room in which the clocks have no hands."

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BULL MARKET EXTENSION IV

Walter Deemer

The market strategist reviews the three bull market extensions since World War II in light of the fourth bull market extension we're currently experiencing.

Since World War II, the stock market has made a cyclical low every four years or so almost like clockwork—with four exceptions, when the low wasn't made until well beyond the normal four-year point. Those four exceptions: 1961, 1987, 2007, and now.

I call these exceptions bull market extensions, since those four bull markets extended well beyond their expected lengths. Let's quickly look at each one.

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Bull Market Extension I took place in 1961. The stock market had made a Four-Year Cycle low in October 1957 (the "Sputnik low"), so the next one was scheduled for October 1961 (as indicated by the arrow on the chart above). The averages didn't peak until December of 1961, though, and then staged an extremely emotional 29% decline that ended with a climactic reversal on May 29, 1962, an undercut low in June, and a successful test of those lows during the Cuban Missile Crisis in October.

The big story of 1961, though, wasn't reflected in the averages. The public—which had finally become a huge factor in the stock market following a 12-year bull run—fueled an incredible speculative binge that peaked in May 1961 in things such as electronics, vending, bowling, and aerospace stocks. (Just how incredible? American Stock Exchange volume exceeded NYSE volume for two days in May 1961, the only time in history it has ever done so.) Speculative stocks then started down, but slow-but-sure growth stocks like P&G and Texas Utilities (which sold at 35 times earnings thanks to a consistent 7% growth rate) carried the averages still higher until December of that year, when the Dow peaked at 25 times earnings.

It was the huge influx of speculative money from the public, though, that really generated the liquidity behind Bull Market Extension I in 1961.

Bull Market Extension II was in 1987 (chart below). The stock market had made a cyclical (and secular) low in August 1982, so the next Four-Year Cycle low was scheduled for August 1986 (again, as indicated by the arrow on the chart). The stock market, however, continued to advance right through August 1987, when it abruptly turned tail and plummeted 36% in less than two months.

And what caused the 1987 bull market extension to take place? It's perhaps best summed up in Louis Rukeyser's Tribune Media Services column of July 10, 1987, where he noted that the stock market was "awash in liquidity" [Emphasis added]. Rukeyser added, "Americans have been storing up cash for years…and with individual investors still notably skittish about stocks, that supply has become a potentially enormous new source of buying."

The market peaked six weeks later.

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Bull Market Extension III (chart below), finally, occurred during—and was undoubtedly aided and abetted by—the Great Real Estate Bubble of 2006, when credit standards were relaxed almost to the point of elimination. The resultant wave of credit expansion, which was focused on real estate, washed over the equity markets as well. The wave of excess liquidity pushed the cyclical peak well past normal expectations and pushed the subsequent Four- Year Cycle low an unprecedented 29 months into the future—but the market suffered a horrific 58% decline in the process.

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This brings us to Bull Market Extension IV, the current one, which has already extended well beyond the time of the expected Four-Year Cycle low (the arrow on the chart below). Why? To me, the answer is obvious: The Fed's unprecedented flooding of the system with money via QE I, QE II, and QE III.

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Which leads me to the following conclusions:

• All four bull market extensions have been associated with periods of unusually high (and in at least some cases, what many would call excessively high) liquidity.

• Although the timing and levels of bull market extension peaks are far, far too variable to lend themselves to any significant conclusions (although past precedents do suggest that the eventual top could lie as far ahead as next March), all three prior bull market extensions led to declines that were far more severe than an "average" bear market.

• Why? I cannot prove it, but I attribute these far-greater-than-average bear markets to the greater-than-usual excesses, from both a time and amplitude standpoint, that built up during the bull market extensions.

•Whenever and wherever the current bull market extension ends, therefore, it is likely to be followed by a greater-than-average bear market.

IMPORTANT DISCLOSURES