FOREWORD BY JOHN MAULDIN

Author of *Just One Thing* and *Bull's Eye Investing*

SIDEWAYS MARKETS

How to Make Money in Markets that Go Nowhere

VITALIY N. KATSENELSON

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OF
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THE LITTLE BOOK

OF SIDEWAYS MARKETS

How to Make Money in Markets That Go Nowhere

VITALIY N. KATSENELSON

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To
Jonah and Hannah

Foreword

The End of the Debt Supercycle and Sideways Markets

It is common among market analysts to talk of secular (long-term) bull and bear markets, but back in the late 1990s I began to notice that markets didn't necessarily march to a neat and tidy bull or bear tune. In my book, *Bull's Eye Investing*, I explained that investors should focus on valuation instead of price, particularly when markets seem to tread water (lots of action, no prolonged movement up or down) for an extended period of time. In other words, there was a third type of secular market: the trendless market.

A few years later, Vitaliy Katsenelson came along and started talking about sideways (Cowardly Lion) markets.

What a clever way to describe these trendless, whipsaw markets that are terribly maddening to investors. This book is a helpful and easy-to-understand guide to navigating these frustrating periods. You need this guidance here and now, because markets are going to go nowhere for some time.

What is a secular sideways market and why do I say it will continue? To see tomorrow, let's take a look back in time. In doing so we'll be able to readily see how valuable this book will be for your portfolio.

A Little Perspective on Time and Behavior

Markets go from long periods of appreciation to long periods of stagnation. These cycles last on average 17 years. If you bought an index in the United States in 1966, it was 1982 before you saw a new high—that was the last secular sideways market in the United States (until the current one). Investing in that market was difficult, to say the least. But buying in the beginning of the next secular bull market in 1982 and holding until 1999 saw an almost 13 times return. Investing was simple and the rising markets made geniuses out of many investors and investment professionals. Since early 2000, markets in much of the developed world have basically been down to flat. Once again, we are in a difficult period. Genius is in short supply.

"But why?" I am often asked. Why don't markets just continue to go up as so many pundits say that "over

the long term" they do? I agree that over the *very* long term, markets do go up. And therein is the problem: Most people are not in the market for *that* long—40 to 90 years. Maybe it's the human desire to live forever that has many focused on that super long-term market performance that looks so good. Or perhaps it is the habit people have of taking their most recent experience and projecting it into the future. As the previous century closed, a good many investors queried in surveys indicated that they thought they would make a compound 15 percent a year from their investments in the stock market. And that expectation was still there a few years later even after a brutal bear market. *Research shows that it takes at least three negative events to persuade people that things have changed.* This is usually just about the time that things are indeed getting ready to change for the better!

History, as Mark Twain said, does not repeat, but it does rhyme. In the 1930s and 1940s we had the Great Depression, a series of policy mistakes, and a war. Stock returns ended up in single digits as the second half of the century dawned. Then we had the boom of the 1950s and on into the 1960s, then a war, a series of policy mistakes, and the tumultuous 1970s with inflation and high interest rates. Then Paul Volcker wrenched the economy into two recessions, bringing stock market returns back to single digits (!). The next 18 years saw a perfect environment for a bull market: falling

interest rates and inflation, new technologies, and a demographic bulge designed to create bull markets and foster optimism—even if punctuated by a recession and several market crashes. As positive year after positive year passed, many assumed that things would be even better the next year. Trees really would grow to the sky.

Then came the bursting of the bubble and the Tech Wreck, a recession, and a vicious short-term bear market in stock prices, especially in the beloved tech sector. But things soon got rolling again and the pundits were proclaiming the return of the bull market. Artificially low rates from the Federal Reserve, tax cuts, and what we now know was a bubble in housing jet-fueled an economic rise around the world. Indeed, a study (co-authored by Alan Greenspan) showed that better than 2 percent (and sometimes almost 3 percent!) of gross domestic product (GDP) growth per year from 2002 to 2006 was basically from people taking out credit against their houses. Without this line of credit, the recession would have lasted over two full years and the next two would have seen GDP growth in the range of a puny 1 percent.

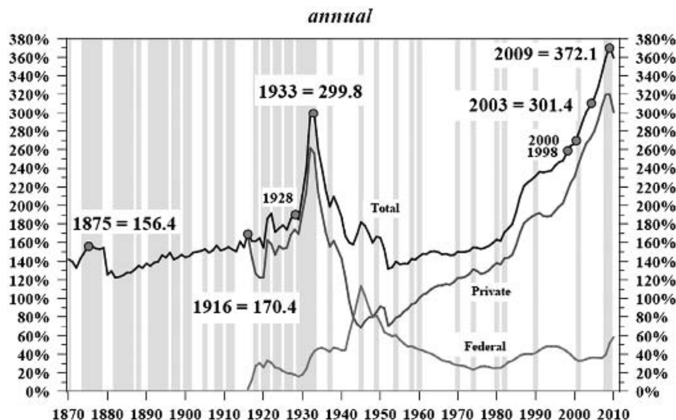
And that brings us to the current environment. Households in the United States and throughout the developing world are beginning to cut back on debt, paying down old bills and taking out less in new debt. But governments in many countries are borrowing ever more money to fund their deficits.

The Endgame of the Debt Supercycle

If the mortgage meltdown was a wake-up call for overextended homeowners, Greece was a warning to governments everywhere that there is a limit to how much debt a government can carry before the lenders call in their IOUs or stop lending. Once the bond markets begin to think you either are not serious about controlling your debt or will not be able to pay it back at something approaching fair value, borrowing costs begin to rise, with interest taking an ever-larger portion of tax revenues. Today, Ireland's debt costs, even though the Irish are serious about cutting spending, are rising rapidly. Tomorrow? It will be any country that does not get its debt under control.

We may not have reached the bottom of the well, but we sense it is near. We have been in a debt supercycle—that ever-growing mountain of debt that has fueled growth—for 60 years. Trees don't grow to the sky and you can't keep piling up more and more debt that takes greater and greater chunks of your income (or GDP). A picture paints a thousand words: When you look at the chart on the next page that shows debt as a percentage of GDP, you clearly see how debt has grown at an ever-faster rate (in the United States, but the data points look very similar for many developed countries). Sometimes debt is good—when it is used for productive purposes such as building factories or creating

U.S. Debt as a % of GDP



Sources: Bureau of Economic Analysis, Federal Reserve, Census Bureau: Historical Statistics of the United States, Colonial Times to 1970. Through Q2 2010.

new businesses—but when it gets spent on consumption, it's just debt that doesn't pay its keep. Think of it this way: If you take out a loan to put your child through college, you are making an investment. When you put your dinner on a credit card and then take three months to pay it off, the debt returns nothing and actually causes your dinner to have cost more than the prices on the menu.

The stimulus bills of 2008 to 2009 helped feed this debt cycle. But even with the government spending, consumers and businesses seem to have wised up and are cutting their debt—even as the government is creating more!

Economics may not be a hard-and-fast science like physics but it does contain at least one mathematical equation that holds true for all countries at all times:

$$GDP = C + I + G + (E - i)$$

or, GDP is equal to Consumption (Consumer and Business) + Investment + Government Spending + Net Exports (Exports − Imports).

The Keynesian economic school of thought says that when C (consumption) is weak, the government should run deficits to boost demand until the consumer is back and ready to spend. This will work. The last stimulus bill that went through the United States and much of Europe had a positive effect on final demand and GDP. But it did so by adding trillions to the debt side of the equation.

We are coming to the limits of government's ability to borrow. In some countries, that limit is very close, whereas in others like the United States, it is a few years off; but people everywhere are waking up to the fact that fiscal deficits need to be brought under control so that their country will not end up with the disastrous choices that Greece and some other countries now face. Don't even get me started on Japan. Japan is a bug in search of a windshield. I leave it to Vitaliy to explain that problem, as you'll read in Chapter 15.

Here is where the equation shows another reality. Reducing any input to the equation is a drag on total GDP. Therefore, if G (government spending) is reduced it will be a drag on GDP. Normally, balanced budgets can be brought about by controlling spending and letting normal growth of an economy catch up with the deficits. But country after country has let their fiscal deficits rise so much, and growth is so weak, that it is going to take either serious spending cuts or new taxes to help bring about the reduction of the fiscal deficits.

In their brilliant and wide-sweeping book, *This Time Is Different* (Princeton University Press, 2009), Professors Carmen Reinhart and Kenneth Rogoff studied 250 financial crises in 60 countries over the past few hundred years. One of their findings is that in the aftermath of credit-crisis-induced recessions, it takes at least six to eight years for countries to get back to normal growth. The ensuing years from the onset of crisis are characterized by slow growth and more volatile and frequent recessions. This follows from countries and their citizens having to get their balance sheets in order, and the former credit induced growth having to now come from a more natural state of organic economic growth, fueled mostly by rising productivity. Slower growth means less of a cushion for normal economic ebbs and flows that seem to occur, like the weather (economic crises will happen from time to time,

not unlike stormy weather). In 1998, the U.S. economy was very strong and could weather an Asian crisis, even as the economy slowed somewhat. Today? The same event would likely push us into a recession.

To the extent that a country can encourage private businesses to invest and start up and current businesses to find new markets and adapt, the length of recessions and slower-growth periods are reduced. The data from Reinhart and Rogoff show that government spending on stimulus, while providing the illusion of the government doing something and a short-term boost (like steroids), does not add to real GDP. Real growth must come from the private sector.

And that takes time. It is just the way it is. Starting a new business that succeeds is not short work. The majority of new businesses fail within five years. But the research shows that new private businesses are the group that creates the net new jobs. Not big business or even small business, but start-ups!

Which Brings Us Back to the Beginning

With the reduction in government spending being a long-term good but a short-term drag, it takes time for a country to get back to a sustainable national budget, because it takes time for a new and thriving private sector to emerge and have the wherewithal to pay more taxes. And that

means we will be in a slower-growth muddle–through economy with uncomfortably higher unemployment for the better part of this next decade. And that means a slower-growth environment for equities from developed countries, which means that you need a new perspective to successfully navigate today's equity markets. You need a different strategy, and Vitaliy helps you find it.

Let's rewind to two points: (1) The data are clear that in the years following a credit crisis, recessions are more volatile and frequent than usual. (2) It typically takes at least three negative events to convince investors that something different is indeed happening. And that is what we are likely to get in the coming six to seven years, which just happens to be the years remaining on the average secular sideways market cycle clock.

Hmmmm.

Could it be that we will see, as we have in past cycles, that stock market valuations in the United States and the rest of the developed world keep dropping? Will they make the full trip as they have done in the past? And will those low valuations, coupled with countries finally (!) getting their fiscal houses in order (and thus removing the drag of a slowing "G") and the entry of a whole slew of new technologies developing in the interim, act like a tightly coiled spring, launching yet another secular bull market cycle? Wouldn't that be an interesting rhyme?

Another thought: There are any number of emerging market countries that are just at the beginning of their debt supercycle. They are not hampered by too much debt, because (luckily for them!) nobody would lend to them. They have a newfound zeal for markets and entrepreneurship. Pay some attention, as they will soon chart their own course apart from the developed world.

In the meantime, we are in a market environment where investors have to be more actively engaged in their investments than before during a bull market when the rising tide lifted all ships. *The Little Book of Sideways Markets* is a life preserver that will help you navigate these perilous waters. Wear it well and wisely.

—John Mauldin

John Mauldin is president of Millennium Wave Investments, three-time best-selling New York Times author, and author of the upcoming The Endgame, The End of the Debt Supercycle *(John Wiley & Sons). He is also the writer of the free weekly e-letter,* Thoughts from the Frontline, *which goes to more than 1.5 million people. For more information, please visit www.johnmauldin.com.*

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First and foremost, I want to express my deepest gratitude to my parents, for believing in me. They always saw a greater potential in me than I believed I possessed, at every step along the way. Through their guidance and never-ending encouragement I rose to be what *they* saw in me, not to what *I* thought I could achieve. Nobody has been more surprised at my achievements than I have. I'll try to do the same for my kids.

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—Vitaliy N. Katsenelson

Introduction

My father's younger sister left Moscow in 1979. I'm not sure whether she was the first Jewish/Russian immigrant to discover Brighton Beach, but she definitely found it before Russian became its primary language. In 1991 she invited my family to the United States. By that time my aunt had divorced and re-married. Her new husband was a rabbi who led a congregation in Cheyenne, Wyoming. With apologies to Wyoming, thankfully we did not move to Cheyenne, but settled about 100 miles south—in Denver.

After folding towels at the health club, busing tables at the Village Inn, and bagging groceries, my first real job was at an investment firm in Golden, Colorado.

I was a junior at the University of Colorado. I was hired because of my computer skills. I wrote a database application that they still use today. They didn't have anything else for me to do computer-wise, so I was promoted to head trader. (Okay, I was their only trader.) *Trader* was a glorified term for my actual position since all I really did was call or fax buy and sell orders. But the job gave me an opportunity to spend a lot of time in front of a Bloomberg terminal and allowed me to talk stocks with portfolio managers. It did not take me long to realize that I loved investing. I changed my major for the sixth and final time, and the rest was history . . . well, almost.

I wanted to be an analyst and they did not need one, so I pulled out the Yellow Pages and sent my résumé to every single investment firm in Denver. I don't know what Michael Conn, Investment Management Associates, Inc. (IMA)'s president, saw in me, since I didn't know much then—perhaps my ambition and hunger for knowledge stood out. Finding somebody willing to pay me to analyze stocks was almost unbelievable.

IMA had been around since 1979 and had a solid investment record. Since its founding, it had owned high-quality companies that consistently grew earnings and traded at reasonable valuations. On my very first day at work Michael Conn, now my partner, proudly showed me his positions in Walgreens, MBNA, and a few other