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Richard Bernstein, founder of Richard Bernstein Advisors, spoke about Profit Cycles around the World: Perception vs. Realty at the CFA Equity Research and Valuation Conference held on November 21-22 in New York City.

Profitability drives stock prices so investors should not spend so much time and effort on macro analysis.

Most investors agree the global credit bubble is deflating. Richard Bernstein wonders, “Why then do investors continue to overweight credit-related assets like gold, hedge funds and commodities that have declined 66%, 73% and 96%, respectively, since 12/31/2008?” This decline in credit-related assets is exactly what should happen as the credit bubble deflates.

Absolute versus Directional Thinking

Despite a sea change in the global economy, there has been no capitulation in demand for credit-related assets leading many investors to miss the biggest bull market of our generation. They are thinking like economists or politicians rather than investors. Politicians and economists think in terms of absolutes – good or bad - while investors care about direction - better or worse.

At the beginning of a market cycle, the economy gets better and better and better before the peak, and then things get worse and worse and worse before the recession bottom. That’s an economic cycle. While the economy is not yet “good”, it is getting better and better, which is what the stock market rally is reflecting.

In the U.S., there are still economic cycles, yet 2008 was so dramatic, many believe we are doomed, overlooking the fact that there are still economic cycles in the U.S. and the economy is getting better and better. Richard likens investors’ responses to following a Shakespearian script. Each script has the same five acts with different story lines, themes and catalysts.

People are reading from a script that says the only reason why the market has been going up is because of the Fed. This is what people say in every early-cycle before the Fed begins to tighten, which is the best time to invest while investors are still fearful. Mid-cycle investing is a little more difficult. Stimulative fiscal and monetary policies drop off, and there is a tug of war between higher rates and growth. Unanticipated positives outweigh the rise in rates. Investors should, therefore, focus on whether the economy is getting better or worse rather than if the economy is good or bad. The most dangerous time to invest is during the late cycle, when everyone wants to invest. This is the time when the Fed increasing interest rates will more than offset business fundamentals.

Three Classic Bear Market Warning Signs

How can investors anticipate a bear market? Richard called out three classic bear warning signs:

1. The Fed tightens too much
2. Significant overvaluation
3. Euphoria for the asset class of choice

Fed Tightens Too Much

The first warning of a bear market occurs when the Fed tightens too much, resulting in an inverted yield curve and a recession. The early 1960s represented the only time an inverted curve wasn’t the kiss of death for the stock market. In 2006 -07, the yield curve became inverted, and bulls explained it away, pointing to technical reasons while calling out different excuses for ignoring the inverted yield curve. Watch the yield curve. Right now the yield curve is quite steep, and it is unlikely that the Fed will prematurely end the cycle. The press implies that the Fed is leading the economy, which is not true. The Fed always lags the economy and will lag more than normal this cycle. Indeed, the Fed posted a piece on their website, indicating they will lag more this time. By the time the Fed changes monetary policy, people will ask, "What took them so long?"

Significant Overvaluation

The second classic warning of a bear market occurs when there is significant overvaluation. Market participants throw away any reasonable valuation model, changing inputs to justify overvaluations. This only happens when there is certainty surrounding the economy and markets. Given the current uncertainty, it is possible the market is undervalued. Four years ago, people were under the desk in a fetal position demanding a very high risk premium for stock investments. Now people are more accepting, but still uncertain of stock investments.

Euphoria for Asset Class of Choice

The third bear market warning sign is euphoria for the asset class of choice while other asset classes are shunned. This bear market warning signal is overwhelmingly consistent throughout history. Given last week's outflows from long-only stock mutual funds, it's clear that stocks are not yet the asset class of choice. Further, pension fund equity allocation is the lowest in 60 years. Indeed, "smart people" are overweight absolute return funds, emerging market debt and private equity. Throughout the bull market of the 1980s and 1990s, Wall Street firms did not even equal-weight equities. When did Wall Street firms overweight equities? During the months leading up to the 2000 bubble. Richard rhetorically asks, "Where is the euphoria?"

Factors people in the U.S. worry about are happening in many emerging markets. Year-over-year money supply growth and CPI is quite extreme in many emerging markets, especially Egypt and India where inflation is above 10%. Employment cost index, retail sales, corporate margins, earnings and revenues growth all are at cycle lows.

Richard notes the disconnect between perception and reality in emerging markets. The sales pitch for global emerging market growth contrasts with the pictures of consumer riots in streets of Russia, Malaysia and Egypt. In reality, consumers in emerging markets are getting squeezed. How can they buy a toaster when they can't afford the bread?

Negative earnings surprises impact stock prices, while positive earnings surprises don't mean as much because of the way Investor Relations manage expectations.

Earnings in emerging market continued to disappoint with more than 50% of companies in BRIC (Brazil, Russia, India, and China) countries reporting negative earnings surprises. For almost two years, profit cycles in emerging markets have been decelerating. Meanwhile, quarter after quarter, emerging market analysts say profits are coming back. Yet, underperformance persists. How can a great growth story have so many disappointing results?

In contrast, 24% of U.S. large-cap companies reported negative earnings surprises. Profits are expected to accelerate during the next 12 months. Small-cap domestic company profits are projected to grow at double the rate of emerging market companies. Developed markets are now a better growth story than emerging markets. The U.S. is now a better long-term growth story than emerging markets. The market is beginning to rotate to the growth story.

Like many Wall Street firms, Richard's former firm chased whatever was popular. In the early eighties, teams of Wall Street analysts followed small-cap stocks. Today, teams of Wall Street analysts follow commodities, and equity analysts follow companies throughout the world, but there are very few small-cap stock analysts.

Richard sees three big equity themes:

1. An American industrial renaissance driven by small and mid-cap domestic companies, not by large multi-national companies.
2. Early Cycle Europe (focus on financials, consumer cyclical and small-cap stocks)
3. Reflating Japan could spark a currency war which will strengthen the dollar. If you are dollar-based, you do not want to own gold.

In conclusion, Richard sees a sea change in the global economy and financial markets characterized by:

- Global credit bubble deflating. Credit-related assets underperforming.
- U.S. and developed markets now a superior growth story.
- Serious secular problems and inflation exist in emerging markets.
- Taper panic will provide opportunities