Bear Market Perspectives

22 October 2008

We live in interesting times. The world economy, first plagued by soaring energy prices, now faces a global credit crisis. Going forward a global recession seems likely according to economists. Despite global stock markets falling some 41% year to date and governments cobbling up a US$3 trillion global rescue plan, investors worry about another down leg in equities. The record high volatility in recent weeks did not help either, leading many investors to suffer from panic attacks or decision paralysis.

History has shown that bear markets come and go, no matter how bad the situation may appear. Eventually the bear dies and a new bull is born. The challenge for investors is to identify when this happens. A study of previous bear markets, using the S&P index, may shed some light on this.

Performance

On average, bear markets fall 32% while the median decline was 36%. The worst was the 1929 stock market crash which saw a 86% decline in stock levels, while the best (least worst) performance was the bear market in 1976-78 and 1998 which saw the S&P 500 fall to the typical definition of a bear market (-20%). The current bear market, which is now down 42%, has surpassed the average and median bear market performance. If we exclude bear markets in the Great Depression era (1929-1940), the current downtrend is now the third worst bear market after the technology bust in 2000-02 (-49%) and the 1973-74 inflation led decline (-48%). Pessimists may argue that we face de-leveraging of epic proportion and that we are now in the worst period since the Great Depression, hence the bear market is likely to exceed even the tech bust. However, the bear markets in 2000-02 and 1973-74 had their fair share of negative factors, extreme overvaluation in the former and raging inflation in the later.

Duration

We are now a year into this bear market. Compared to the average or median bear market duration, we have some six months more to go before we can call the current bear market typical. The worst in terms of duration was the 1939-1942 bear market which lasted 41.5 months, while the best was as short as 1.5 months in 1998. Given that the last bear market in 2000-02 lasted some 30.5 months, it is not surprising that investors would expect the current bear market to labour on for another while longer.

Seasonality

Previous bear markets have shown a tendency to end in October. Out of the past 16 bear markets, five (or 31%) ended in October while three ended in March. The saying that the stock market tends to do well in the November to April period may partially explain this. If seasonality prevails, then perhaps we could see a bottom soon?

S&P Index Bear Markets						
Date of Market Peak	Peak Level	Date of Market Trough	Ending Month	Trough Level	Peak to Trough Performance	Duration of Bear Market (months)
Sep 7 1929	31.92	Jul 8 1932	Jul	4.41	-86%	34
Jul 18 1933	12.2	Mar 14 1935	Mar	8.06	-34%	20
Mar 10 1937	18.68	Mar 31 1938	Mar	8.5	-54%	12.5
Nov 9 1938	13.79	Apr 28 1942	Apr	7.47	-46%	41.5
May 29 1946	19.25	Jun 13 1949	Jun	13.55	-30%	36.5
Aug 2 1956	49.75	Oct 22 1957	Oct	38.98	-22%	14.5
Dec 12 1961	72.64	Jun 26 1962	Jun	52.32	-28%	6.5
Feb 9 1966	94.06	Oct 7 1966	Oct	73.2	-22%	8
Nov 29 1968	108.37	May 26 1970	May	69.29	-36%	18
Jan 11 1973	120.24	Oct 3 1974	Oct	62.28	-48%	20.5
Sep 21 1976	107.83	Mar 6 1978	Mar	86.9	-19%	17.5
Nov 28 1980	140.52	Aug 12 1982	Aug	102.42	-27%	20.5
Aug 25 1987	336.77	Dec 4 1987	Dec	223.92	-34%	3.5
Jul 16 1990	368.95	Oct 11 1990	Oct	295.46	-20%	3
Jul 17 1998	1186.75	Aug 31 1998	Aug	957.28	-19%	1.5
Mar 24 2000	1527.46	Oct 9 2002	Oct	776.76	-49%	30.5
Oct 9 2007	**1565.15**	**Today?**	**Oct?**	**907.84**	**-42%**	**12**

Economy to worsen

Investors may next ask how the bear market can end when the economy is just starting to deteriorate. Well, stock markets are a discounting mechanism. They look ahead of the current situation and anticipate events six to nine months ahead. For example, unemployment in the US, a key economic data that affects sentiment, typically rise and continue to rise even after the bear market has ended. Since 1948 when employment data was first compiled, there were ten out of twelve times where the unemployment rate continue to climb for one to 20 months after the bear market ended.

Bear market bottom to peak unemployment	Bear market bottom unemployment rate (%)	Peak unemployment rate (%)	No. of months
Oct 90 - Jun 92	5.9	7.8	20
Oct 66 - Oct 67	3.7	4	12
Oct 57 - Jul 58	4.5	7.5	9
Oct 02 - Jun 03	5.7	6.3	8
May 70 - Dec 70	4.8	6.1	7
Oct 74 - May 75	6	9	7
Jun 49 - Oct 49	6.2	7.9	4
Aug 82 - Nov 82	9.8	10.8	3
Jun 62 - Aug 62	5.5	5.7	2
Aug 98- Sep 98	4.5	4.6	1
		Average	***7.3***

More often than not, stock markets also lead the way out of recessions. Since 1929, there were eight instances where the S&P index bottomed before the US economy recovered from a recession. The logical explanation for this is that equity investors, like entrepreneurs, assume risks that should be rewarding in the future. Stocks are bought in anticipation of a recovery in the economy and corporate profits.

US Stock Market Bottomed	US Economy Bottomed*	Stocks bottom earlier than economy
Jul 8 1932	Mar-33	yes
Mar 31 1938	Jun-38	yes
Jun 13 1949	Oct-49	yes
Oct 22 1957	Apr-58	yes
May 26 1970	Nov-70	yes
Oct 3 1974	Mar-75	yes
Aug 12 1982	Nov-82	yes
Oct 11 1990	Mar-91	yes
Jun 26 1962	Feb-61	no
Oct 9 2002	Nov-01	no

** as determined by the National Bureau of Economic Research*

The challenge in the current investment climate is to invest with the right perspectives. When we do get over the credit crisis, the next worry for investors is the impact on the global economy. The world economy has been slowing for a while and it would not come as a surprise if the National Bureau of Economic Research indicates that the US was in a recession since late 2007. Given the amount of money governments around the world is willing to throw at the global economy, it is possible that an economic recovery is not too far off, provided there are no more policy mis-steps. If stock markets continue to serve as a leading indicator, then a bottom may be at hand. Lean on history and statistics for a better perspective.

Simon Liew
Investment Strategist