

Bear markets; bear-market rallies and what the future could hold

This paper is part of an advice series commissioned by CommSec Margin Lending

12 May 2009

Key points

- We counted 13 bear markets in the All Ordinaries since 1875. Surprisingly, they are not all different. Indeed, we make claims that the current market is a good match for five others. The other seven seem to fall into three groups (slow, shallow and fast) but there are not enough of each type to form a strong opinion about these smaller groups.
- While drawing conclusions from past performance is less than encouraged in our industry, we can say that if this bear market has just ended it will seem a dead ringer for 1973/4 and 1929/30. The others were similar for the first part of the fall but they then recovered from a higher level.
- The five similar (completed) bear markets ended by reclaiming half of their losses in less than a year or two and being back to the pre-bear peaks in four or five years or less. The slowest of these recoveries to the top was 9% p.a. excluding dividends.

Executive Summary

The big question everyone seems to be asking at the moment is, "Have we seen the bottom of the market yet?" One smart answer I heard on TV the other day was that, "it was certainly one of them". Not very useful as an investment call but one which rings so clear to those who have been watching the market day after day, after day.

We have experienced 13 bear markets since 1875 (by our definition) but, so far, only 12 recoveries. We analyse "every bear that ever there was" to search for any common patterns that shed any light on what might be ahead for the 13th recovery.

Of the 13 bear markets, there is a visually surprising similarity between the current market and five others. Visual analysis is not a science so other interpretations might prevail – we leave our

readers to form their own opinions (with a little help from us) about what might transpire.

No bear market has been deeper than the current but two are ballpark the same (1929/30 and 1973/4). Three others (1941/2, 1951/2 and 1981/2) had a strikingly similar path downwards until they turned up for a recovery. All five of the completed similar bear markets bounced back with impressive returns. Investors fearful of bear market rallies (rallies that seem to start as a bull run only to fade away) should invest before a recovery is fully underway – or wait for the first part of a bull run to be over. Otherwise, these investors might find themselves buying at a local peak and then feeling the need to jump ship before the bull run really gets going.

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This report is published, approved and distributed by the Commonwealth Securities Limited ABN 60 067 254 399 AFSL 238814.

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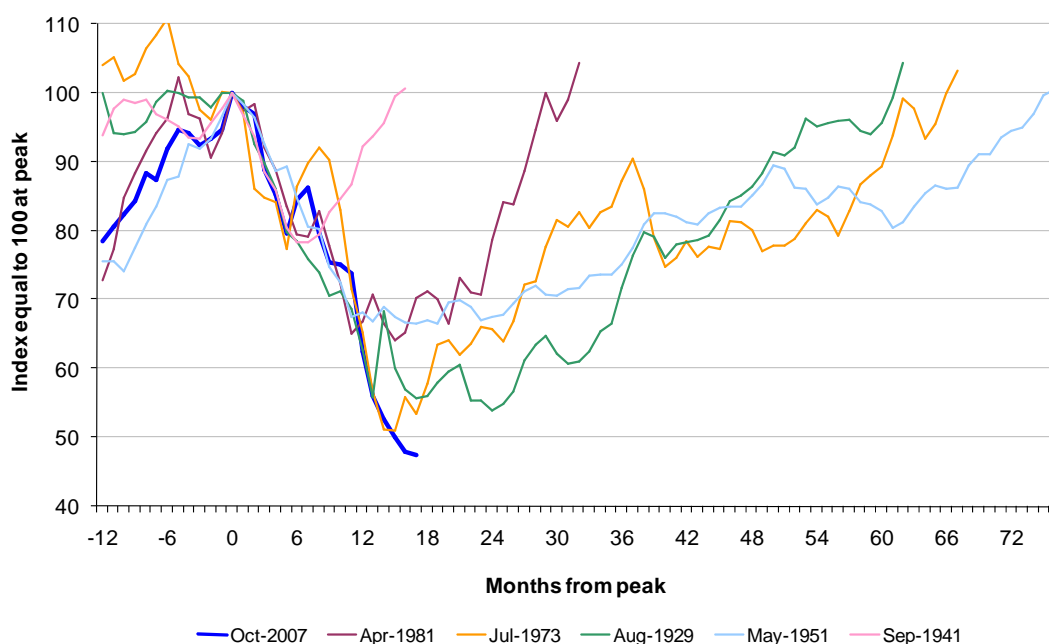
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Section 1: A visual analysis

Let's keep the analysis simple. Details of our approach are relegated to the end of the paper. We use monthly average price data on the All Ordinaries from 1875 and define the peaks as the last month before the market really started to fall. In some cases this means that a slightly higher value might have occurred in the few preceding months as the market was topping out.

We lined up all of the 13 bear markets we found on a scale that co-locates the peaks and uses the months from the peaks we selected as the horizontal axis. Each peak is scaled to be 100. While that spaghetti map (not shown) was very confused we saw what we believe to be an important set of patterns. No visual analysis is unique but we found this one compelling. Two bear markets seemed to have a lot in common with the present (1929/30 and 1973/74). Three of the others are very close for the first part of the run down but then they recover much sooner: 1941/2 fell 22%, 1981/2 fell about 35% as did 1951/2. We show each of these 'similar' bears in Figure 1 using the month and year of the peak to label the series. We show the common trends down using a magnified scale in Figure 2.

Figure 1: Six similar bear markets?



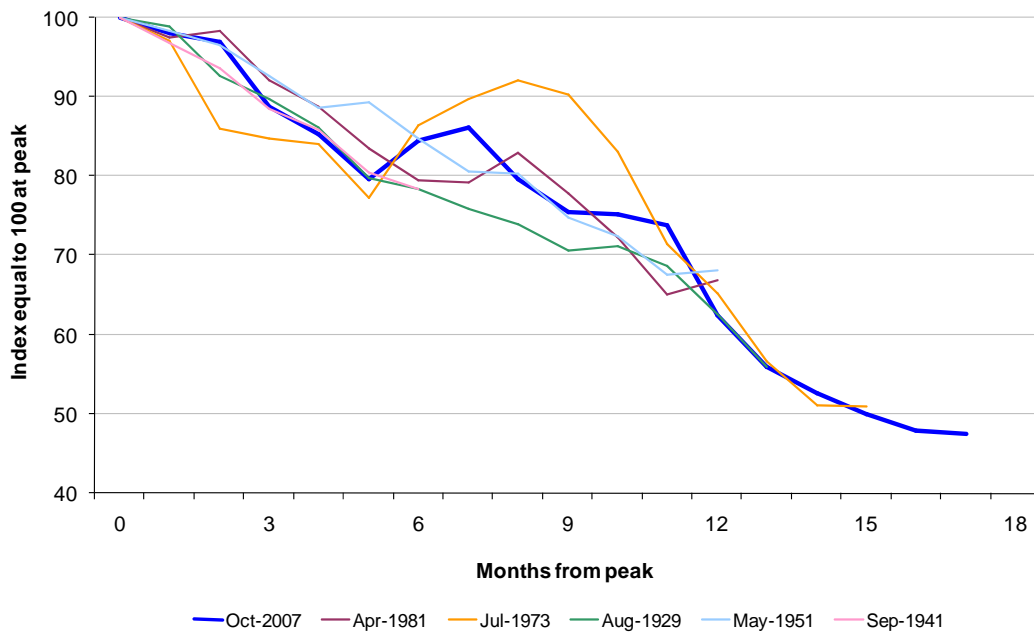
Source: Wren Research, Investment Research

Before we report our analysis of the recovery phases, we turn our attention to how different the other seven bear markets have been. We found that three groups can conveniently describe the rest: the slow, the shallow, and the fast. With only two or three of each type per category, it is difficult to draw the conclusion that this is the best taxonomy. Since our aim is to focus on the current market and its similar predecessors this is not a major issue.

We categorised 1888/9 and 1937/8 as slow bear markets which we show in Figure 3. They each took about five years to reach the bottom at about 30% - 35% off the peak. Except for a few months in 1972, the three markets,

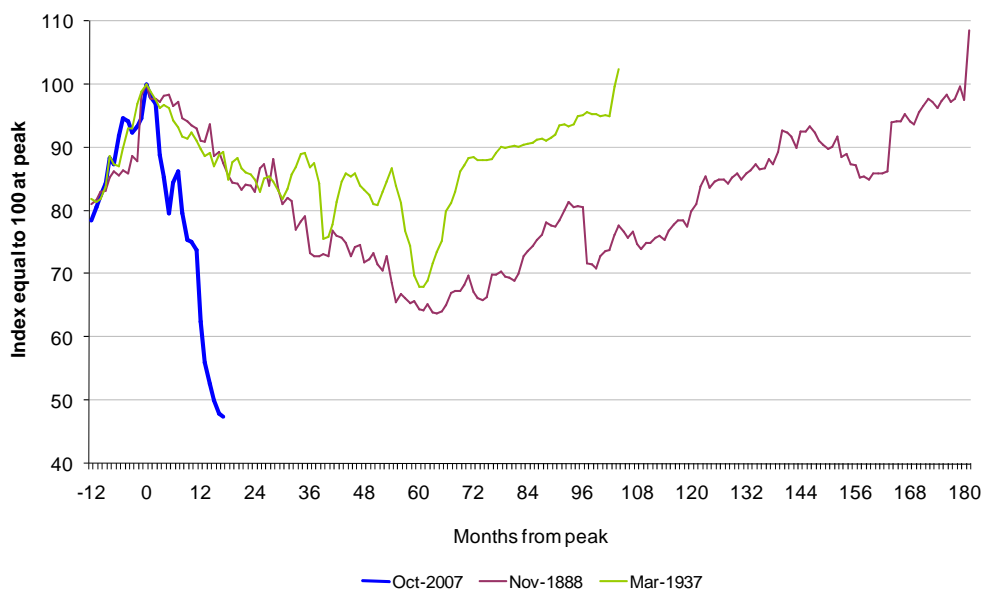
1878/9, 1915/6 and 1970/1 (Figure 4) were shallow with bottoms in the 20% - 25% range from the peak. The 1970/1 got close to, but not quite, the previous peak before it descended in the 1973/4 bear market - which was deep. We find this classification as there being two bear markets in the early to mid 1970's far more useful than combining them. Finally, 1875/6 and 1987/8 (Figure 5) had sharp descents but the patterns thereafter have little in common.

Figure 2: The common trends



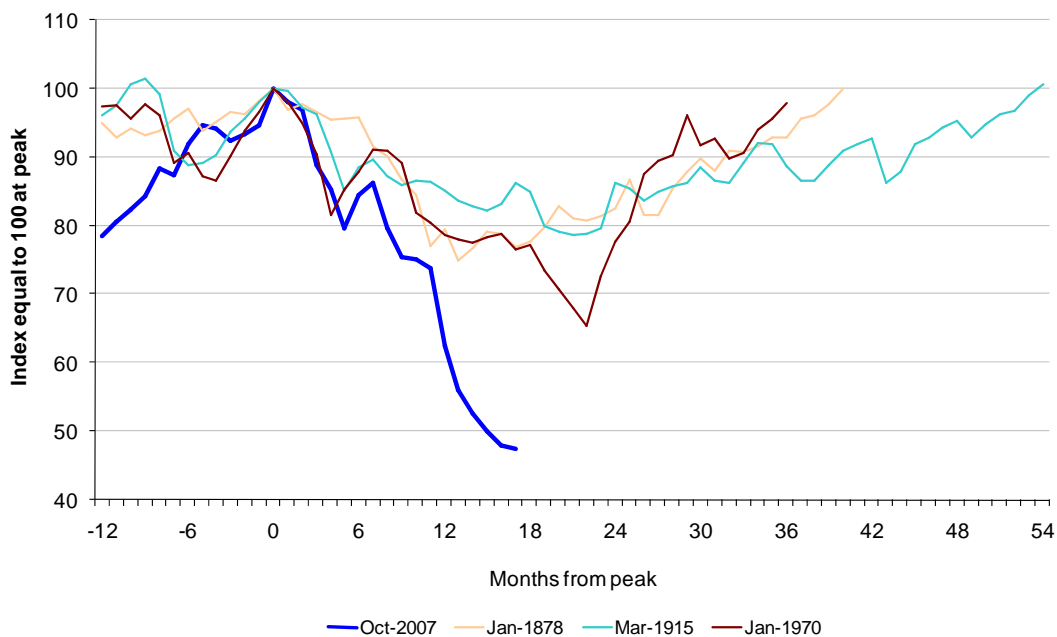
Source: Wren Research, Investment Research

Figure 3: Two slow bear markets



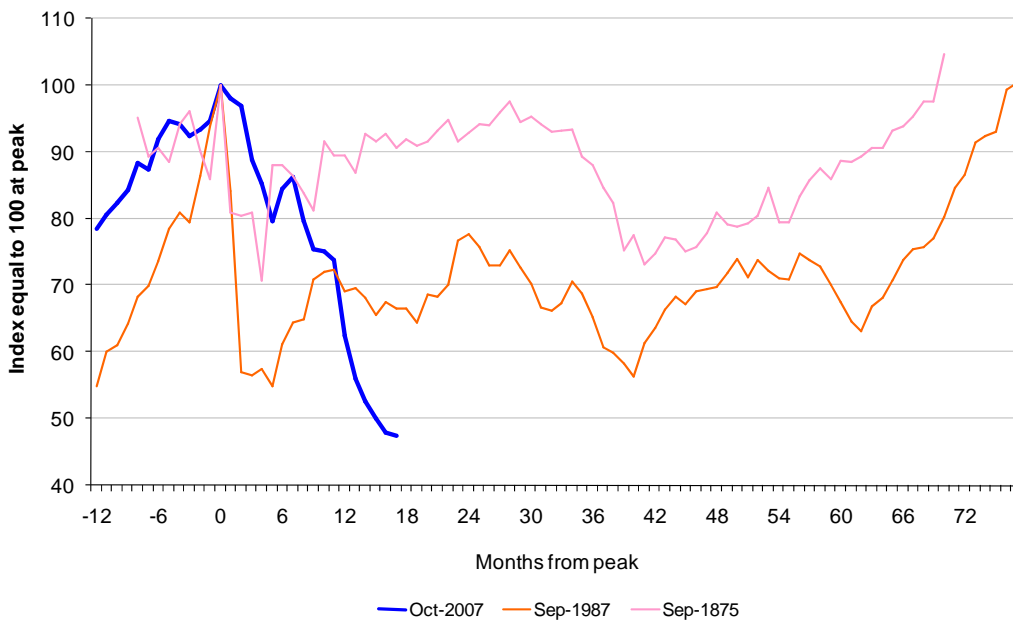
Source: Wren Research, Investment Research

Figure 4: Three shallow bear markets



Source: Wren Research, Investment Research

Figure 5: Two fast bear markets



Source: Wren Research, Investment Research

Section 2: A recovery analysis

If we focus on the six so-called similar bear markets we can deduce what has happened with a view to speculating what might happen next. The future is dependent on company and macroeconomic fundamentals as well as sentiment. Elsewhere we have written that we believe the fundamentals are strong and the market is under-priced. If that is the case, then it is as much human behaviour as anything else that will drive the recovery – when it comes.

That we have never experienced a bear market worse than this – using our definitions – and five have something in common with the present, we conjecture it will take a change in fundamentals – not sentiment – that would send the current market significantly lower. Of course day-to-day whims can move the market several percent – which is another reason why we are using monthly averages.

If we have bottomed – and that is supported to some extent by our research on earnings, dividends, shipping freight and macroeconomic commentary – what will happen next. We summarise the past falls and rises in Table 1. Using an ‘extremes’ analysis over 138 years we can say the market has never fallen more in a single bear market, the slowest retracement to 50% back to the peak was 28 months with an average of 14 months. The slowest retracement back to the previous peak was 59 months with an average of 35 months. The slowest growth rate back to the top was 9% with an average of 24%.

If dividend yields are set to stay moderately strong, largely because of the price fall, as our research of consensus brokers suggests, performing the worst we have ever recovered from such a slump (growth 9% pa) with reasonable dividends in our opinion suggests the long-term investor in the index or a well-diversified portfolio of blue chips could well be handsomely rewarded. Of course the rule of entering the market carefully - with some form of dollar cost averaging – and monitoring risk through changes in circumstance are essential.

Table 1: Fall and rise of six similar bear markets

Market	Fall		Retracement (months)		Recovery rate (pa)
	Months	Size	50%	100%	
Aug-1929	24	-46%	14	38	21%
Sep-1941	6	-22%	6	10	35%
May-1951	17	-34%	28	59	9%
Jul-1973	15	-49%	14	52	17%
Apr-1981	15	-36%	10	17	37%
Oct-2007	17	-52%	?	?	?
Average	16	-40%	14	35	24%

NB: Oct-2007 bear market may not be over.

Source: Investment Research

Conclusions

Until March 10th 2009 the majority of commentators seemed to be calling for possibly another new low with some in the range 2,700 to 2,900. The S&P500 staged the third best week since the Second World War in the week that followed leading to a weaker rally in Australia but at least some degree of optimism started to emerge. Is it a bear market rally or the start of a bull run?

Of course we (and everyone else) will not know for sure until it is truly all over. For long term investors not currently in the market (but, say, in cash) the decision to start to get set now depends upon the views of future yield and capital gains. As we have written recently elsewhere, dividends for blue chips are holding up well so with lower prices (consensus) expected yields are more attractive than cash – especially after tax.

The market may well dip yet again before it fully recovers but the consensus earnings forecasts of the blue chips look good if not great even in the short run. The real danger to long-term investors is to hold off until a rally is well under way – say 20% or so from the bottom – only to find another market correction. If such investors then bail out, having been burned by the experience, they might not return to the market for an extended period missing out on future potential gains.

Since our analysis shows this is the deepest bear market to date – but we have been there before and recovered – it might be time to try to earn some of that equity risk premium that such investors have been missing since 2007.

Notes

We use monthly average price data on the All Ordinaries from 1875. We use monthly data partly because of availability but more importantly we don't want a false sense of accuracy from using daily data over 138 years! We chose peaks by finding those dates for which no month in the four preceding or ensuing years were higher and there was a fall of at least 20% from the highest month. In a few cases we shift the data back a few months and re-define the peaks to make a better match of the real descent rather than the plateau before the fall.

We allowed an exception to the rule by allowing the short sharp 1941 bear market in. We have not knowingly ignored any other reasonable bear market.

The 1971/2 and 1973/4 were also treated slightly differently. They could be taken to be one long bear market with a major bear-market rally. However, given the way we have defined the peak of the 1971/2 bear market, the data do reach the previous 'peak' before the second bear market.

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