Business and Private Banking

Investment Research

CommSec

The Crab market

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

12 May 2009

Prelude

In early April we were commissioned by CommSec Margin Lending to write a paper about the 'year that was'. What we thought would be interesting is to look at a paper we published back on 11th February 2009 about what was happening in the market at the time and the similarities with the 1987 stock market crash. Since this time we've seen a new low in the market on March 6th followed by a strong rally. The consequences of which, and what could follow, are discussed in Section 2. All other sections of this paper are the original from that published in February.

Key points

- **There are bull markets, bear markets and what we call "crab markets" – the ones that just keep going sideways. The S&P/ASX200 has been bouncing along lows of 3350ish since mid November 2008 – and highs of under 3800.**
- **When will it end and which way will it go? While this bottom seems to have been around a very long time, it has strong parallels with the 1987 crash and rebound. While charts can at best back up an argument – not prove one - we might get ready for a charge north just in case!**
- **With the US, China and Australia all launching stimulus packages, interest rates falling, and the Baltic Dry Index leaping at a record pace, now seems to have the backing for the market to recover – if only for the medium term.**

Executive Summary

Every bear market probably seems different from all those before – when you are in it. After the event similarities often emerge as the emotion disappears and the factual analysis begins.

The 1987 crash was so different from the current bear market. In both cases the falls to the bottoms were of the same order of magnitude but the 1987 crash was swift and harsh – the current long and punishing.

We find that if we abstract from all the noise around and focus on October 1, 1987 to February 1988 and October 1, 2008 to February 2009 a strange similarity appears. Both markets had a double bottom (mid November and early February with each containing a 10%-15% bear-market rally in between.

While we do not know what will happen next, we do know that from 10th February 1988, the market rallied

Authors:

Prof Ron Bewley PhD, FASSA – Chief Investment Officer, PCS

nearly 30% within a month and 40% within four months.

Is there a cause for optimism this time around? In the United States the new administration is in the process of releasing TARP II and a massive stimulus package. In China another stimulus package could reignite resource demand – and the Baltic Dry Index points to that possibility. In Australia, rates have tumbled to record lows and unemployment is well below 5%. Of course the government here too is about to release a stimulus package.

A rally seems on the cards. Will it be sustainable? We do not know but we argue here and elsewhere our volatility measures have to show some stability in the markets before a rally kicks on. While our measure (irrational volatility and cross-sectional volatility) are not at the appropriate levels (between the "tram" lines) for stability, they are very close and closing in.

Authors:

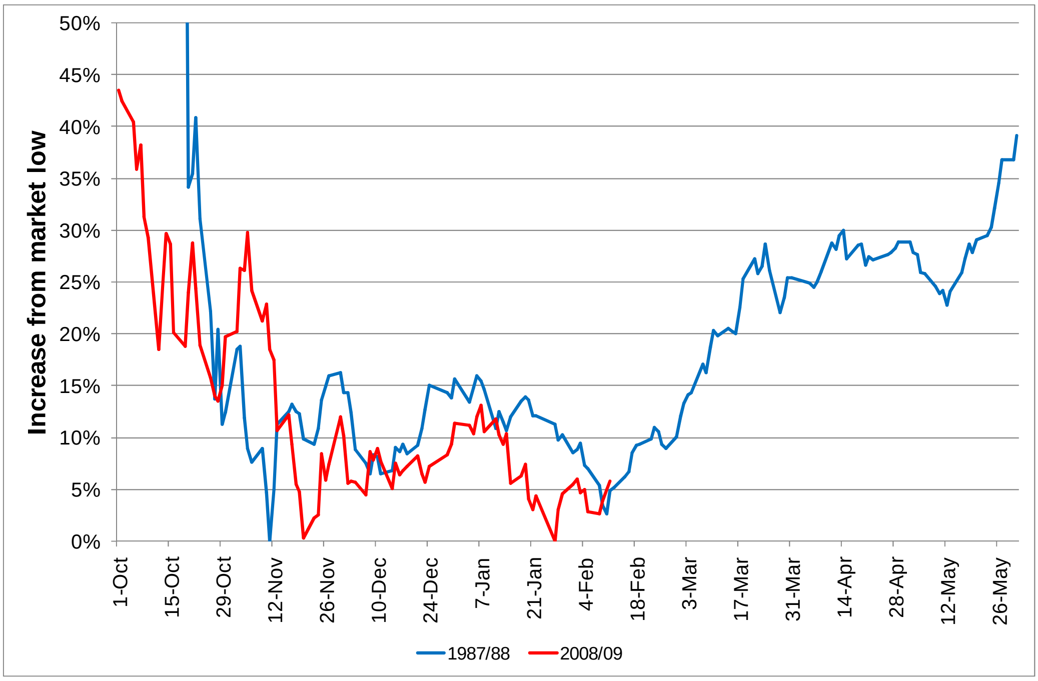
Prof Ron Bewley PhD, FASSA – Chief Investment Officer, PCS

Section 1: A comparison with 1987/88

We were drawn to a comparison with the 1987 crash because that was short and sharp while the current has been slow and debilitating. Almost by chance we lined the two series up (1987/88 and 2008/09) so that the October 1st coincided and we used percentage increases from the low as the measure.

What surprised us was that when the before and afters are removed both bottoms (to date) have been almost the same. The same length, the same double bottom and the same bounce in between. We show this comparison in Figure 1.

Figure 1: Standardised representations of the S&P/ASX200 bottoms of 1987/88 and 2008/09



Source: IRESS, Investment Research

Beauty is in the eye of the beholder – as are visual interpretations of charts. What we see is a remarkable similarity between the two entries to the bottom and, to date, patterns at the bottom. We vividly remember TV program after TV program around the 1987/88 bottom as many nervously awaited the second crash – just like some now. Was the possibility of a rally of 30% - 40% - as witnessed in 1988 any more extreme then as a claim that it could happen again now?

As we reported in this week's Market Monitor, the ducks are lining up to form a nice row – irrational volatility and cross-sectional volatility are at reasonable levels but not quite low enough for a sustainable recovery – yet. In this week's other Market Matters, we discuss in detail how the shipping index (Baltic Dry Index) is rocketing up signalling possible iron-ore shipments to China are recovering. Of course, in Australia, interest rates are down, stimulus packages are being launched and, despite all the gloom and doom, unemployment is almost at record lows.

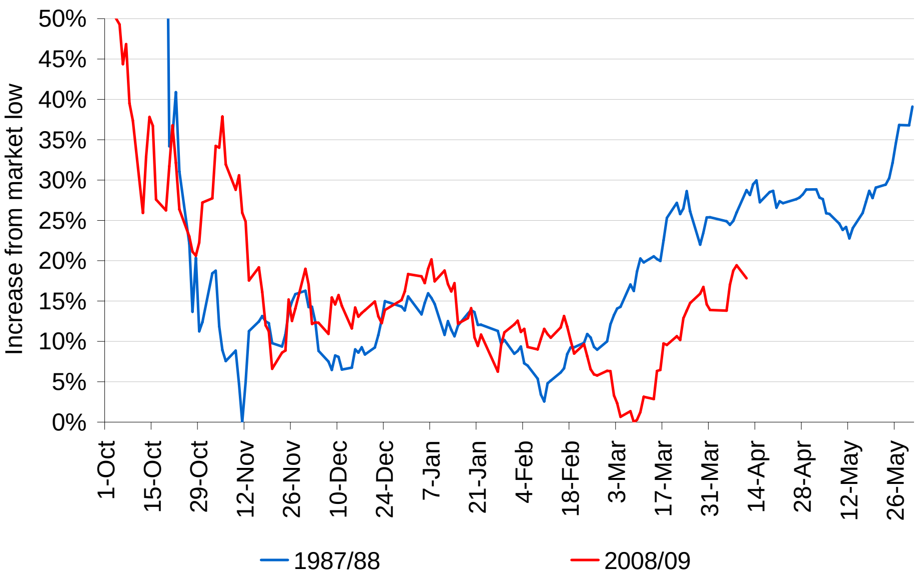
While the real economy in Australia is likely to weaken, it will do so from a very strong base. Markets often recover before the real economy does as investors are valuing a stream of future profits. The S&P/ASX200 has failed to take up several recent overnight leads from Wall Street in the Dow Jones and our futures index SPI. Perhaps it won't take much for the market to make a charge – if only for a while.

Section 2: Updated crab market

Our original paper (published 11th February 2009) argued that markets have and can bounce back sharply after a fall but that nothing is guaranteed. While a bounce back would definitely have been preferred, instead, since this time we have seen a new market low (occurring on March 6th). Interestingly, the strong recovery since this new low continues to be broadly in line with the 1987 experience. While again there is no guarantee that we will continue this upwards trajectory like we did back then completely dismissing it as a possibility could prove to be unwise.

Our paper titled *'Bear markets; bear-market rallies and what the future could hold'* which is also part of this series analyses all bear markets that have occurred since 1875 – providing a broader context for the current experience. From this analysis, our conclusion is that we may well have seen the bottom but like always (in good times, bad times and in crab markets) markets do go up and down so a number of small to medium corrections is not out of the question if indeed our supposition of continued long-term growth is correct. Additionally, the high and relatively stable dividend yields on offer by many of the big stocks also help to position equities as an important part of any well-diversified portfolio. However, volatility remains high so investors must continue to exercise caution and entering the market using a dollar-cost averaging type approach is essential.

Figure 2: Standardised representations of the S&P/ASX200 bottoms of 1987/88 and 2008/09 (data up to 7 April 2009)



Source: IRESS, Investment Research

DISCLOSURE AND DISCLAIMER APPENDIX

Important Information: CommSec Margin Lending is a unit of the Commonwealth Bank Group of Companies. The Commonwealth Bank of Australia ABN 48 123 123 124 AFSL 234945 ("the Bank") is incorporated in Australia with limited liability. Commonwealth Securities Limited ABN 60 067 254 399 AFSL 238814 ("CommSec"), is a wholly owned, but non-guaranteed, subsidiary of the Bank and a participant of the ASX Group Please view our website at research.commbank.com.au for further important disclosure information.

Important Information Appendix - All Investors: The Bank and its subsidiaries, including CommSec, Commonwealth Australia Securities LLC, CBA Europe Ltd, Commonwealth Private Ltd, Commonwealth Research and Investment Research, are domestic or foreign entities or business areas of the Commonwealth Bank Group of Companies (CBGOC). CBGOC and their directors, employees and representatives are referred to in this Appendix as "the Group". This report is published solely for informational purposes and is not to be construed as a solicitation or an offer to buy any securities or financial instruments. This report has been prepared without taking account of the objectives, financial situation and capacity to bear loss, knowledge, experience or needs of any specific person who may receive this report. No member of the Group does, or is required to, assess the appropriateness or suitability of the report for recipients who therefore do not benefit from any regulatory protections in this regard. All recipients should, before acting on the information in this report, consider the appropriateness and suitability of the information, having regard to their own objectives, financial situation and needs, and, if necessary seek the appropriate professional, foreign exchange or financial advice regarding the content of this report.

We believe that the information in this report is correct and any opinions, conclusions or recommendations are reasonably held or made, based on the information available at the time of its compilation, but no representation or warranty, either expressed or implied, is made or provided as to accuracy, reliability or completeness of any statement made in this report. Any opinions, conclusions or recommendations set forth in this report are subject to change without notice and may differ or be contrary to the opinions, conclusions or recommendations expressed elsewhere by the Group. We are under no obligation to, and do not, update or keep current the information contained in this report. The Group does not accept any liability for any loss or damage arising out of the use of all or any part of this report. Any valuations, projections and forecasts contained in this report are based on a number of assumptions and estimates and are subject to contingencies and uncertainties. Different assumptions and estimates could result in materially different results. The Group does not represent or warrant that any of these valuations, projections or forecasts, or any of the underlying assumptions or estimates, will be met. Past performance is not a reliable indicator of future performance. The Group has provided, provides, or seeks to provide, investment banking, capital markets and/or other services, including financial services, to the companies described in the report and their associates. This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or other jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would subject any entity within the Group to any registration or licensing requirement within such jurisdiction. All material presented in this report, unless specifically indicated otherwise, is under copyright to the Group. None of the material, nor its content, nor any copy of it, may be altered in any way, transmitted to, copied or distributed to any other party, without the prior written permission of the appropriate entity within the Group. In the case of certain products, the Bank or one of its related bodies corporate is or may be the only market maker. The Group, its agents, associates and clients have or have had long or short positions in the securities or other financial instruments referred to herein, and may at any time make purchases and/or sales in such interests or securities as principal or agent, including selling to or buying from clients on a principal basis and may engage in transactions in a manner inconsistent with this report.

All investors - Analyst Certification and Disclaimer: Each research analyst, primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers; and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the report. The analyst(s) responsible for the preparation of this report may interact with trading desk personnel, sales personnel and other constituencies for the purpose of gathering, synthesizing, and interpreting market information. Directors or employees of the Group may serve or may have served as officers or directors of the subject company of this report. The compensation of analysts who prepared this report is determined exclusively by research management and senior management (not including investment banking). No inducement has been or will be received by the Group from the subject of this report or its associates to undertake the research or make the recommendations. The research staff responsible for this report receive a salary and a bonus that is dependent on a number of factors including their performance and the overall financial performance of the Group, including its profits derived from investment banking, sales and trading revenue.