**Philequity Corner (August 6, 2007)**
**By Valentino Sy**

## Is the bull market over?

Over the past two weeks, Philequity has received a lot of inquiries regarding the recent market downturn. Some investors have voiced that the sell-off might be more severe than the last or that it might take more time to recover. Many, in fact, have asked if the bull market is finally over. In the US, analysts use a decline of more than 10 percent or a fall down to the 200-day moving average to indicate the start of a bear market. So far, the Dow Jones Industrial Average (DJIA) which closed at 13,181 last Friday is down by only 7 percent from its peak and is way above its 200-day moving average of 12,783. Therefore, technically, we are not yet in a bear market.

One thing for sure, this correction did not come unexpected. We've already mentioned this in previous articles where we've also outlined the reasons why we expect the market to correct. Finally, the correction has come. However, we also said that while we expected a correction, nobody knows the timing and the duration of the decline.

(For those who want to catch our past articles, please refer to www.philequity.net or Philequity Corner at www.yehey.com/finance.).

## Anatomy of a stock market correction

In order to understand the future, we have to look at the past. In this article, we look at past market corrections (some term it crashes). Specifically, we will focus on market corrections triggered by financial crises, similar to the sub-prime market fallout that we are currently facing. We will review the causes that triggered the crisis, the extent of damage to the financial markets and the economy, and lastly, how the crisis was dealt with.

### 1) Savings and Loans Crisis in the 1980s

Deregulation in the early 1980s caused a rapid growth in Savings & Loans (S&L) institutions. Many S&Ls took advantage of the lack of supervision and regulations to make highly speculative investments, in many cases loaning more than they could handle. And when the real estate market of the 1980s crashed, many S&Ls went bankrupt taking, along with their depositors' money. The ultimate cost of the crisis is estimated to have totaled $150 billion, about $125 billion of which was consequently and directly subsidized by the US government.

### 2) Black Monday Crash in October 1987

The US stock market had banner years leading to the 1987 crash. The bull market, which started in 1982, had been fueled by IPOs, hostile takeovers, leveraged buyouts (LBOs) and merger mania. The stock market advanced significantly, peaking in August 1987 with the DJIA up 44 percent from end-1986. This was followed by a series of volatile days that caused widespread nervousness leading up to the crash.

On October 19, 1987 (a.k.a Black Monday), the DJIA lost 22.6 percent of its value or equivalent to $500 billion in market capitalization. The most popular explanation for the crash was the selling of program traders. Program trading (through the advent of computers) allowed instantaneous execution of orders to buy or sell large batches of stocks and futures. Many blamed program trading for blindly selling stocks, exacerbating the decline. The US Fed had to intervene to prevent a depression and a banking crisis. Short-term interest rates were instantly lowered to provide liquidity in the market. Remarkably, the market recovered quickly from the worst one-day market crash.

**3) LTCM crisis in 1998**

The hedge fund Long-Term Capital Management was founded in 1994 by John Meriwether and an all-star group of traders and academics, which included two Nobel-prize winning economists. At its peak, LTCM's portfolio swelled to over $100 billion while its net asset value stood at around $4 billion; its swaps position is valued at some $1.25 trillion notional, equal to 5 percent of the entire global market.

When Russia devalued its ruble and declared moratorium on 281 billion rubles worth of Treasury debt, the result was a massive "flight to quality" with investors flooding out of any remotely risky market and into the most secure investments. The resulting liquidity crisis, ultimately, dealt a severe blow to LTCM's portfolio. To avoid the threat of a systemic crisis in the world financial system, the US Fed orchestrated a $3.5 billion rescue package from leading US investment and commercial banks, including LTCM's creditors, in exchange for 90 percent of LTCM's equity and control of management of the fund.

**DJIA Performance during Financial Crises**

| | | Dow Jones % gain/(loss) after the event/reaction | | | |
|---|---|---|---|---|---|
| **Event** | **Duration** | **%gain/loss** | **22 days** | **63 days** | **126 days** |
| Hunt Silver Crisis | Feb 13 to Mar 27, 1980 | -15.9% | 6.7% | -4.0% | 6.8% |
| S&L Crisis | Apr 27, 1981 to Jun 18, 1982 | -23.5% | 5.7% | 18.0% | 29.9% |
| 87 Black Monday Panic | Oct 2 to 19, 1987 | -34.2% | 11.5% | 11.4% | 15.0% |
| LTCM Crisis | Aug 18 to Oct 8, 1998 | -11.3% | 15.1% | 24.7% | 33.7% |
| Enron/Worldcom Scandals | Apr 15 to Jul 24, 2002 | -25.3% | 7.6% | -4.3% | 6.5% |
| **Average** | | **-22.0%** | **9.3%** | **9.2%** | **18.4%** |
| Subprime Fallout | Jul 19, 2007 to ? | ? | ? | ? | ? |

*Source: Philequity Research, Bigcharts.com*

On the average, the DJIA loses 22 percent during financial crises. The market, however, has recovered an average of 9.3 percent after 22 days and 9.2 percent after 63 days. After 126 days, the DJIA has made new highs after the S&L crisis and the LTCM crisis. In the other instances, the DJIA made new highs after around a year.

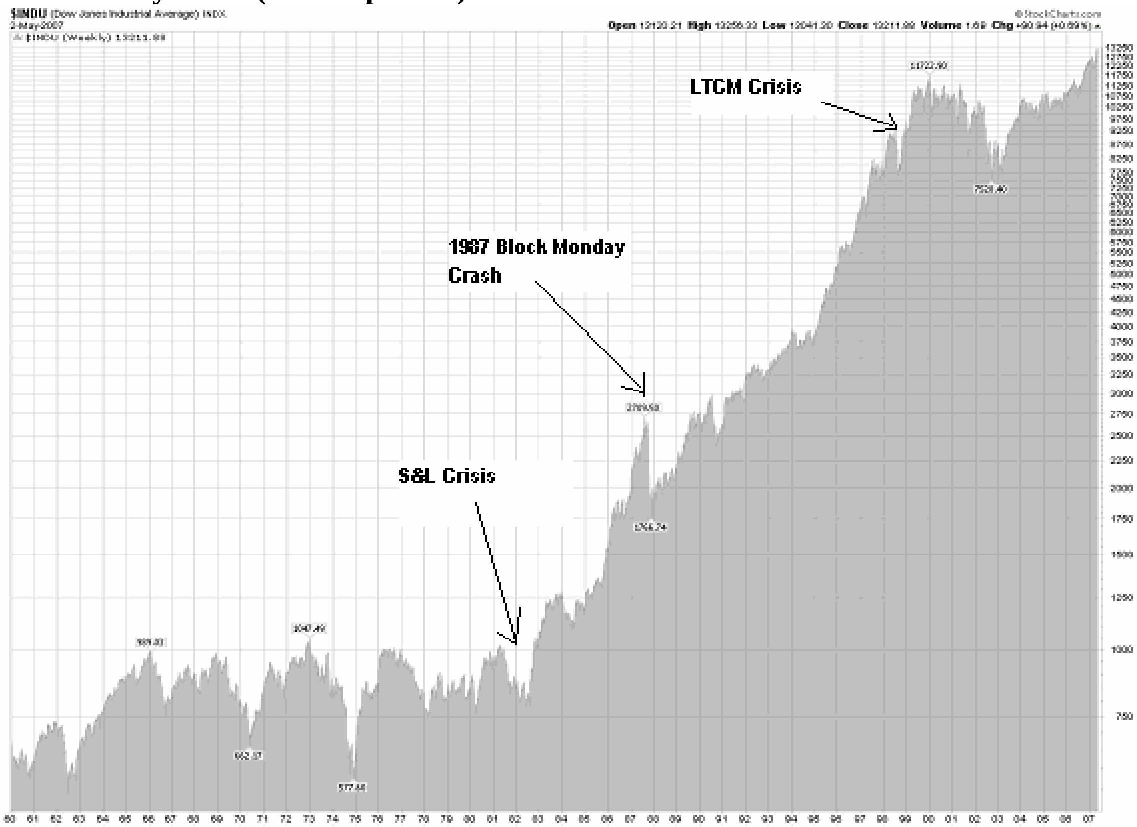
Today, the DJIA has so far dropped 7 percent, following the sub-prime market fallout. We don't know the extent and how much longer the decline will take. However, as we have seen in the past, the market (in time) recovers.

**What have we learned?**

Looking back at the previous market corrections, we learn that the extent of the corrections and their duration vary widely. Some corrections, took a long time to effect like the one during the S&L crisis when the market was in a decline for more than a year. On the other hand, there are corrections like the 1987 Stock Market Panic which only took more than two weeks, but the extent of the decline was severe at 34.2 percent.

We have also learned that when we rationally stand back and look at these market setbacks, we should be glad for the opportunities to buy at discounted prices. As prices decline, future returns increase, it is really that simple. And as long as stocks are well chosen and are bought at appropriate valuations, investors won't get brutalized by the market downturn. Moreover, looking at a longer time horizon, these setbacks will just be squiggles on the chart.

**DJIA Weekly Chart (1960 to present)**




*Source: Stockcharts.com*

Lastly, the most important thing that we've learned is the market's resiliency. Somehow, the market has a way of recovering and adjusting after every setback. Therefore, we should not underestimate the market and economy from recovering from this current malaise.

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