Philequity Corner
By Valentino Sy (November 17, 2008)

The Yo-yo Dow

Given the wild volatility, extremely oversold conditions, historically low valuations, coordinated government intervention and unprecedented spike in investors' fear index (VIX), there is a reasonable chance that the stock market is in a bottoming process, notwithstanding a looming recession.

While it is difficult to forecast the length of the bottoming phase and even trickier to accurately pinpoint the bottom, it is clear that stocks are now priced to deliver significantly high *long-term* returns.

Bear Traps

To get a better gauge of the future of the market, we have to study the past. And because the US was the source of the subprime collapse and the global credit crunch, we have to closely watch the developments in the US economy and their financial market as discussed in *Bear Watching* (see Philequity Corner in the July 21, 2008 issue of **The Philippine Star**).

In terms of depth the current market decline is the third greatest decline since the Great Depression of the 1930s. At its low in October 2008, the Dow Jones Industrial Average (DJIA) was down -44.5 percent from its October 2007 peak.

Other major drops of at least 40 percent were the 1987 Black October Crash (-41.2 percent), the 1973-1974 Oil Crisis (-46.6 percent), and 1939-1942 World War 2 (-41.3 percent) and the 1937-1938 Crash (-50.2 percent). Of course, the 1929-1932 Great Depression was the most devastating, with the market dropping -89.5 percent.

DJIA Biggest Drops (1929 – 2008)

Period	%Drop	No. of Months	Accompanied by Recession
1929-1932	-89.5%	35	Yes
1937-1938	-50.2%	13	Yes
1939-1942	-41.3%	32	
1946-1949	-24.7%	38	Yes
1956-1957	-20.6%	19	Yes
1961-1962	-29.2%	8	Yes
1966	-26.5%	9	
1968-1970	-33.5%	18	Yes
1973-1974	-46.6%	24	Yes
1976-1978	-28.2%	19	
1981-1982	-25.3%	17	Yes
1987	-41.2%	3	
1990	-22.5%	4	Yes
1998	-29.0%	3	
2000-2002	-38.7%	33	Yes
2007-2008	-44.5%	14	Yes

Source: Bloomberg, Philequity Research

Swift, brutal, massive, pervasive

The main characteristics and difference of this bear market is its swiftness, brutality, global pervasiveness - encompassing all assets. In less than two months, stock markets dropped massively, and many stocks like the materials and the financials dropped 70 – 80 percent in value in such short a time. There was no escaping either. All assets were viciously dragged down by the bear onslaught.

Birthday Bear

In terms of duration, the average bear market since the 1930s lasted for 18 months. The current bear market is already 14 months old.

Except for the 1929-1933 Great Depression which lasted for 43 months, the longest recession the US experienced was 16 months during the 1973-1974 Oil Crisis. But since Europe and Japan are also in recession, a number of analysts are saying that the current contraction in the US will last longer than usual. This recession in the US, which started in the 4th quarter of 2007, is expected to last up to 4th quarter of 2009.

Nevertheless, the stock market is the most reliable leading economic indicator turning up about midway into a recession. So if this recession lasts 24 months as expected and it is already in the middle of the contraction cycle, then the stock market is already in the bottoming out phase.

Fighting back

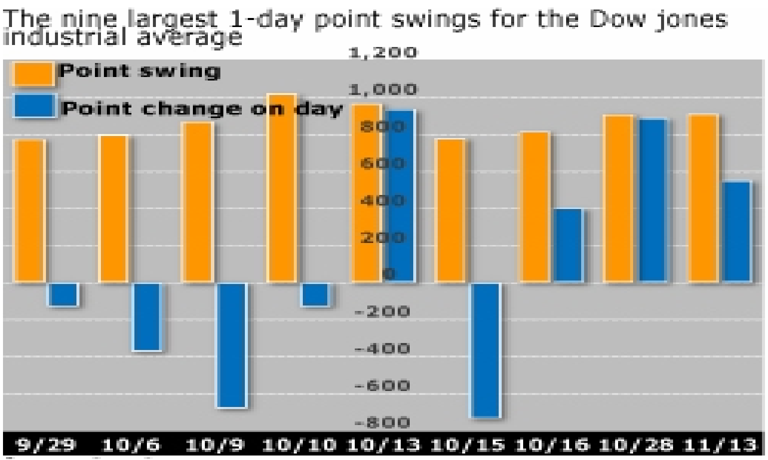
Up to the first half of 2008, the bear market decline had been typical of that experienced during past recessions. However, the Lehman bankruptcy changed the financial landscape altogether. In our view the Lehman collapse was a monumental blunder which almost caused the collapse of the financial system. This is why after a brief rally in April and May panic selling ensued triggered by fear, the liquidity squeeze and the consequent deleveraging by hedge funds.

Governments around the world has since gotten their act together, and in a concerted effort, addressed the problem with coordinated rate cuts, massive liquidity infusion, and economic stimuli packages.

Up, Down, Up, Down

In our article *Bubbles Bursting* (see Philequity Corner in the Oct. 27, 2008 issue of **The Philippine Star**), we mentioned that sentiment indicators currently point to a possible turn in the market. The CBOE Volatility Index or the so-called investors "fear index" (which tend to spike near major lows) shot to a record high in October.

Meanwhile, the chart below shows that in the past 1 ½ months alone, the Dow Jones Industrial Average registered its nine largest 1-day point swings. Note that prices often exhibit wild swings during market tops and bottoms.



Source: Dow Jones

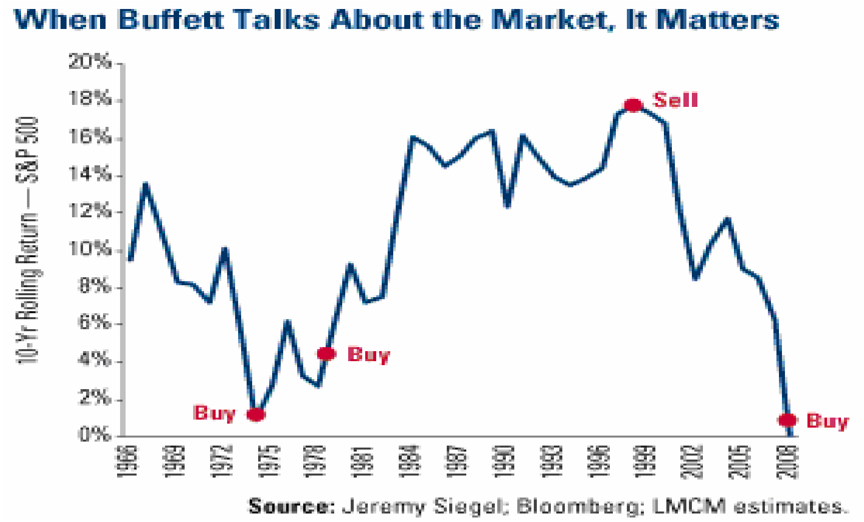
Finding Value

With the DJIA down 40 percent and now trading slightly above 10x last year's peak earnings level, it is not surprising that prominent value investors (e.g. Warren Buffett, GMO's Jeremy Grantham, Vanguard's John Bogle, Fidelity's Anthony Bolton, Dr. John Hussman, Stephen Leuthold, and others) are all taking advantage.

Warren Buffett even made publicized "Buy" call on US stocks as mentioned in *Cash and Courage* (see Philequity Corner in the Oct. 20, 2008 issue of The Philippine Star). Aside from Buffett's recent investments in Goldman Sachs and General Electric, his company Berkshire Hathaway was revealed to have become the largest shareholder in oil producer Conoco Phillips. Berkshire also bought a substantial stake in manufacturer Eaton Corp in the 3rd quarter of 2008.

Betting against Buffett?

While not your typical market timer, Buffett's track record in timing the market with his publicized calls has been impeccable.



People are quick to dismiss Buffett's advice, saying that he is getting in too early and that he didn't understand how bad the economy is going to get. Buffett made the right calls in 1974, 1979, 1999. Are we going to bet against him in 2008 and 2009?

As Buffett notes, "fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now… If you wait for the robins, spring will be over."

Definitely, more bad news are forthcoming. The US will enter a prolonged recession. There will be more bankruptcies, earnings disappointments and analysts' downgrades. But at this point of the market downturn, for long-term investors the rewards clearly outweigh the risks