Philequity Corner
By Valentino Sy (December 1, 2008)

Santa Claus Halts the Horror Show

Despite all the gloomy forecasts and bad economic numbers, the US markets registered its biggest 5-day gains since 1932. The Dow Jones Industrial Average (DJIA) which closed at 8,829.04 last week, gained 1,277 points or 17 percent in just five sessions after the Fed committed as much as $800 billion to help resuscitate the lending markets and investors speculated President-elect Barack Obama's economic team will bolster growth.

After the horrific plunge of most financial assets during the past four months, are we seeing the end of the continuous deterioration of financial assets? Is the financial nightmare over? Or is this a pause before the resumption of the sell-off? Did Santa Claus come early to stop the bear onslaught? Are we going to see a Santa Claus rally that will carry the market up to January? Or have we seen the bottom of the market? Is the horror show finished?

Americans still shell-shocked

Despite the rally, the Americans are still shell-shocked after the huge losses suffered this year. The current financial turmoil seems to have no precedent because so many Americans have not lived through a period with so much volatility and devastation such as now. Major indices are down about 50 percent, and many financial and material stocks are down 80 to 90 percent from last year's peaks. In fact, one has to go back as far as the Great Depression before one can find a similar situation.

Here in Asia, in 1997, we have experienced something like this before. We have seen the prices of our bank and property stocks decimated by 80 to 90 percent, and our own PSE Index reduced by 70 percent. We have seen entire countries, not just industries or sectors, being bailed out. We have seen the entire region fall into recession.

But, in time, our engines of growth recovered. Our economies came back with healthier fiscal and external positions. Our banks are now more stable and with stronger balance sheets. Stocks have recouped their losses, and most issues even made new highs as discussed in *US Credit Crisis and Bailouts – Reminiscent of 1997 Asian Financial Crisis* (see March 17, 2008 issue of **The Philippine Star**).

Not the time to bail out

If one looks back at Asia in 1997-98, one realizes how much the recent decline in the US may have already discounted potential economic negatives. At this point, further declines in stock prices simply increase the long-term returns that investors can expect over time. This is not the time to bail out because prices are deeply oversold and undervalued, and stocks offer extremely high long-term returns to the buyers. Long-term investors who bail out at attractive valuations are not *investors* at all.

Bottoming out

Over the past few weeks, we have noted that the stock market, despite all the bad news, is now on a bottoming process.

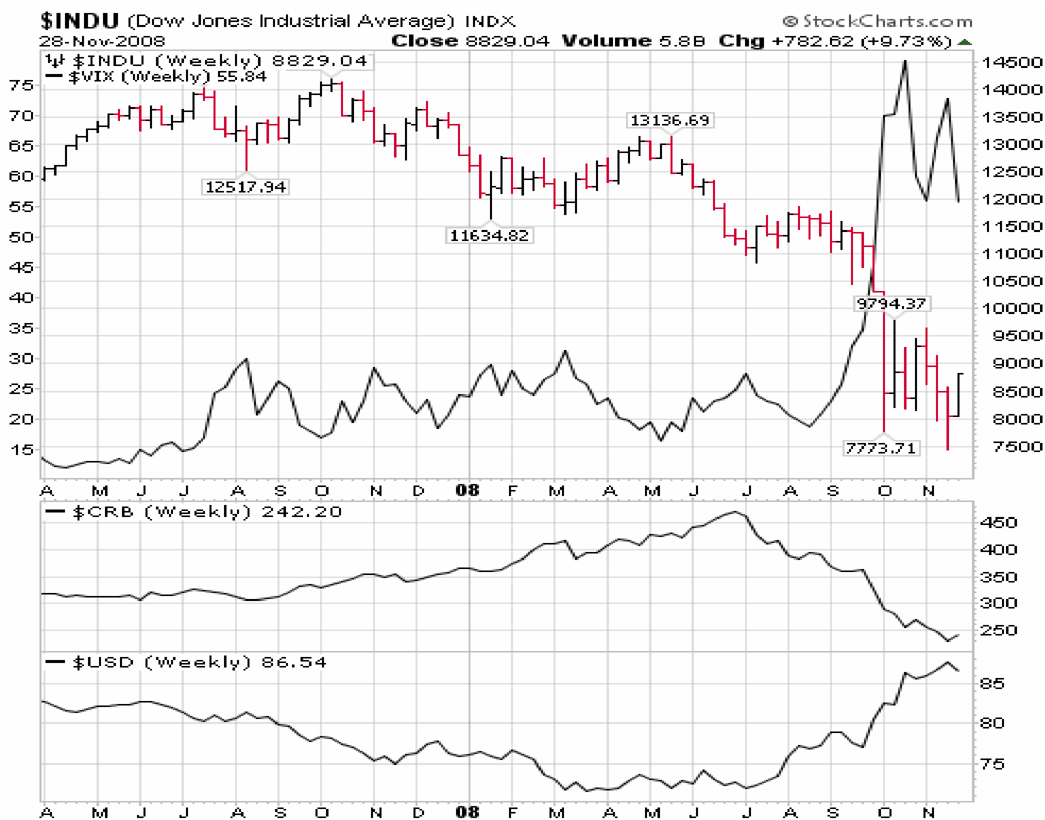
In our article *Cash and Courage* (see Philequity Corner in the Oct. 20, 2008 issue of **The Philippine Star**), we said that "*those with cash and courage and with a long-term time horizon will be rewarded by this once-in-a-generation opportunity*."

In *Bubbles Bursting* (see Philequity Corner in the Oct. 27, 2008 issue of **The Philippine Star**), we stated that "*despite all the gloom and doom, there are signals that a turn in the market is near.*"

In *Opportunity of a Generation* (see Philequity Corner in the Nov. 3, 2008 of **The Philippine Star**), we said that "*the market is fairly cheap…dividend yields have risen to attractive levels*."

In *The Yo-yo Dow* (see Philequity Corner in the Nov. 17, 2008 of **The Philippine Star**), we stated that "*definitely, more bad news are forthcoming … 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.*"

Clearly, there are positive indicators pointing to, at least, an intermediate term bottom in the markets. For one, the VIX index (a.k.a investor's "fear index") which reached a record high of 89.53 in October is now below its 50-day moving average. Second, the US dollar appears to be turning downwards, which means that the deleveraging and margin calls (which triggered the massive liquidation in almost all assets) are abating. Third, the CRB index is reversing its recent decline which suggests that the Fed and other central banks attempt at reflating the economy is gaining traction.

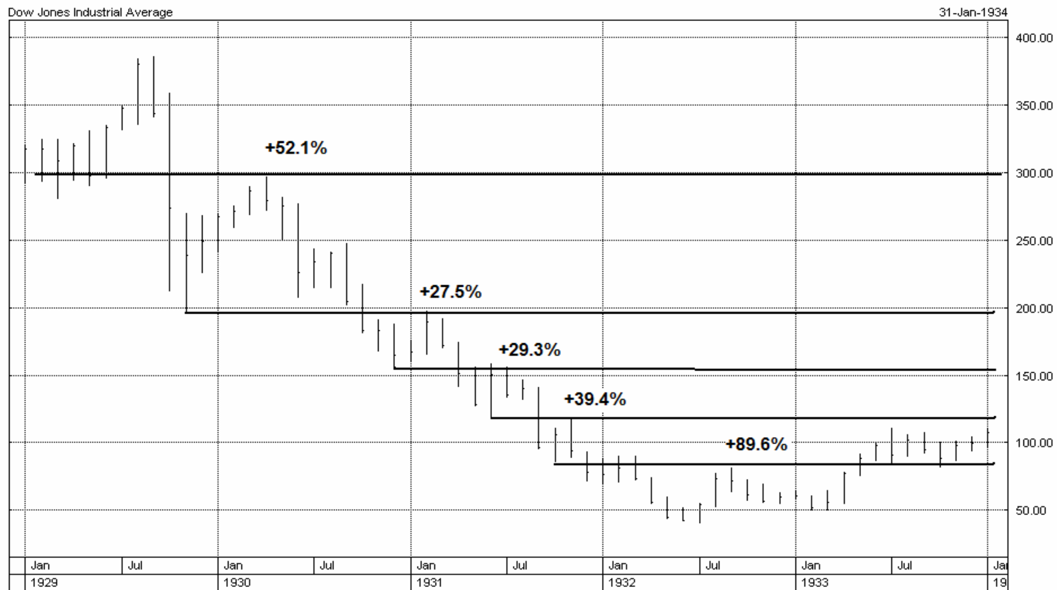


Meanwhile, credit stress measures such as the TED spread (difference between 3-month dollar LIBOR and 3-month Treasury Bills) and the OIS spread (difference between the LIBOR rate and Overnight Index Swap) has significantly improved although not yet back to pre-Lehman bankruptcy levels.

Even dead cats bounce

What if the indicators are wrong? What if the US authorities make a monumental blunder like letting Lehman go bankrupt? Let's assume for the sake of argument that the US will fall into a depression and we have not yet seen the ultimate low. But stock prices do not rise or fall, for that matter, in a linear fashion. Even during the Great Depression of the 1930s (see chart

below), the stock market did not fall 89.5 percent without making huge rebounds to previous support levels.



As you can see, after falling by almost half from its 1929 peak (similar to the extent of the current decline), the DJIA rallied by 52.1 percent. Subsequent breaks of previous lows (marked by horizontal bars) were followed several months later by a rebound to those prior support levels. So, even during prolonged declines, it rarely made sense for investors to sell at extremely oversold conditions because markets tend to rally back to the prior level of support.

For sure, there will be more bad news coming out such as those reported last week. But one must remember that after every panic, the news doesn't have to be good for stocks to rally, it just have to be less worse than what has already been discounted.