Lessons from the Past

No one knows exactly how this bear market and the inevitable recovery will play out. However, the past can give us insights into how events might unfold. To that end, Tacita Capital analyzed the 9 recession-induced bear markets and recoveries in the U.S. since 1929. We restricted our analysis to recession-induced bear markets since it is likely that the U.S. is now in a recession and bear markets triggered by recessions (e.g. 1973/74) are deeper and longer than bear markets triggered by market crisis (e.g. October 1987 or August 1998).

Lesson 1: It might still get worse.

On Friday, October 10th, the S&P 500 closed at a cyclical low of 899, down 43 percent from the peak on October 9th, 2007. The speed of the descent was unprecedented as the S&P had its worst week on record. Yet, although this painful decline slightly outpaced the average bear market decline of 41 percent (see Table I in the attached Appendix), 4 of the 9 prior bear markets resulted in even great losses. Excluding the Great Depression (an outcome we believe to be a low probability given the speed and magnitude of government and central bank responses), the largest decline was 55 percent in 1937/38.

Lesson 2: We are much closer to the bottom than the top.

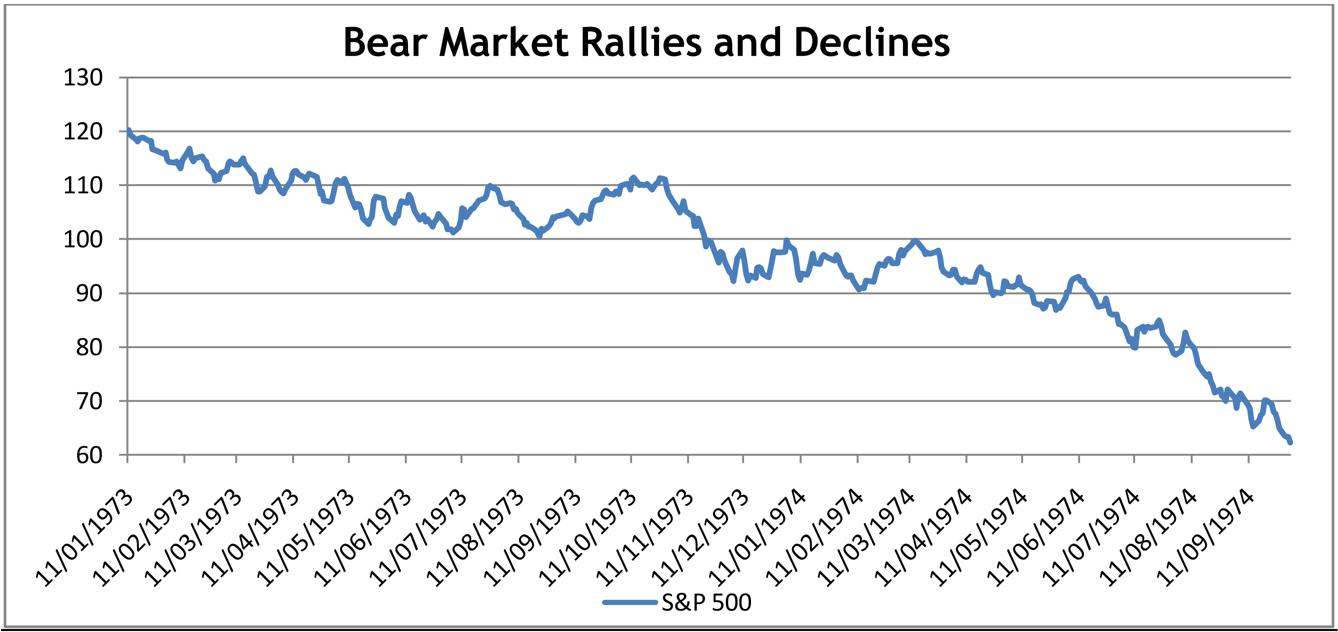
A silver lining to the dizzying descent is that if October 10th was not the market bottom, then we are much closer to the eventual trough. While picking a market bottom depends more on serendipity than skill, we analyzed a number of historic market peak and trough indicators (e.g. price earnings ratios, dividend yields, GDP and profit declines) as well as possible technical floors to get a sense of a reasonable worst case scenario (see Table II). Our findings indicate that if the market continues to slide due to a deep recession, the S&P 500 should find an eventual bottom somewhere between 690 and 841.

Lesson 3: The odds are that it won't be over quickly.

The current bear market is now one year old. Unfortunately, the typical recessionary bear runs 21 months and the longer the economy contracts, the longer stocks are pummelled. The classic example is the 1973/74 bear market, which ran 21 months as the economy contracted 2.7 percent from mid-1973 to early 1975. Then again, we may get lucky – in the severe downturn in 1937/1938, the bear market lasted 13 months.

Lesson 4: There will be relief rallies along the way.

Every bear market has been punctuated by numerous relief rallies. The decline is never straight down as is evidenced by the following chart depicting the 1973/74 bear market. Only in hindsight do we know whether a rally is temporary or the start of a lasting recovery.



Lesson 5: If you wait for the economy to recover, you will miss the market bottom.

In every bear market, the stock market bottomed out before the economy turns up except in 2000/02 when the tech wreck exacerbated the market decline. The market upturn typically begins 6 months before the recession ends, but can lead by as little as 4 months or as long as 11 months.

Lesson 6: Dividends buffer price declines.

Dividends do not fall nearly as far or as fast as stock prices during a bear market. In the past 9 bear markets, dividends actually grew modestly on average. Only in 3 of these bear markets did dividend payments decline and, excluding the Great Depression, the average decline was a modest 4.1 percent. Current dividend yields on large cap stock indexes ranging anywhere from 3 to nearly 6 percent can ameliorate any further price declines.

Lesson 7: The recovery pays for the decline and then some.

Every bear market has been followed by a period of strongly rising stock prices. In fact, the average increase from one recession-induced bear market to the next has been a stunning 208 percent (see Table III). The lowest was the 74 percent increase in the 1970's while the greatest was over 400 percent in the 1990's. There were temporary set-backs triggered by economic slowdowns such as in 1966 or crises of confidence such as the August 1998 Russian meltdown, but the truest measure of a market recovery – the market's movement from one recessionary bear to the next - is a rewarding gain that more than compensates for the pain of the declines. History demonstrates that the patient, long-term investor is well rewarded.

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TACITA CAPITAL

Table I

Recessionary Bear Markets – S&P 500

Peak Date	Peak High*	Trough Date	Trough Low*	Loss
7-Sep-29	31.92	1-Jun-32	4.4	-86.2%
6-Mar-37	18.68	31-Mar-38	8.5	-54.5%
29-May-46	19.25	13-Jun-49	13.55	-26.9%
2-Aug-56	49.74	22-Oct-57	38.98	-21.6%
29-Nov-68	108.37	26-May-70	69.29	-36.1%
11-Jan-73	120.24	03-Oct-74	62.28	-48.2%
28-Nov-80	140.52	12-Aug-82	102.42	-27.1%
16-Jul-90	368.95	11-Oct-90	295.46	-19.9%
24-Mar-00	1527.46	9-Oct-02	776.76	-49.1%
9-Oct-07	1565.15	?	?	?
AVERAGE				**-41.1%**

Table II

Method	S&P 500 Bottom
Trough Price Earnings*	835
Trough Dividend Payout**	841
Decline Below Last Low***	690
Worst Decline ex Great Depression****	712
Decline in 1973/74	811
October 9, 2002 Low	777
Intra-Day Low - October 10, 2008	840
AVERAGE	**787**

*Based on 2007 S&P 500 Core Earnings reduced by average recessionary profit decline of 4.0% (excludes the Great Depression and WWII) times the average market bottom price earnings ratio of 12.3.

** Based on current S&P 500 cash dividends grossed up to average bear market historic payout levels, divided by the average trough market dividend yield of 6.1%.

*** Based on the 1930's and 1970's average experience where the market low slipped below the prior bear market low

**** Based on market decline in 1937 and 1938 where annual real GDP declined by 3.25%

Table III

S&P 500 Recovery Markets

Trough		Peak		
Date	High	Date	Low	Gain
1-Jun-32	4.4	6-Mar-37	18.68	324.5%
31-Mar-38	8.5	29-May-46	19.25	126.5%
13-Jun-49	13.55	2-Aug-56	49.74	267.1%
22-Oct-57	38.98	29-Nov-68	108.37	178.0%
26-May-70	69.29	11-Jan-73	120.24	73.5%
03-Oct-74	62.28	28-Nov-80	140.52	125.6%
12-Aug-82	102.42	16-Jul-90	368.95	260.2%
11-Oct-90	295.46	24-Mar-00	1527.46	417.0%
9-Oct-02	776.76	9-Oct-07	1565.15	101.5%
AVERAGE				**208.2%**