

What Happens When a Cyclical Bull Meets a Secular Bear

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Alpha Plus
ADVISORS



SUMMARY

History can be defined by two kinds of investment environments, 1) those related to economic cycles which create *cyclical* bull and bear markets, and 2) investment periods that occur roughly once in a generation, known as *secular* bull and bear markets. Both environments exist simultaneously as economic recessions and expansions unfold within long-term secular trends. The purpose of this paper is to examine stock market behavior during secular bear markets from the past.¹ Primary conclusions are,

- If the current bear market remains within the parameters of the 20th century, it will end between 2012 and 2021.
- The maximum decline and duration of secular bear markets have shown a tendency to moderate over the past two centuries, although the moderation has not always occurred in each consecutive event.
- Since the inception of the Dow Jones Industrial Average in 1896, a secular bear environment has existed 46% of the time. Furthermore, recessions are more likely, as 68% of all recession months have occurred during secular bear periods.
- The low on November 20, 2008 represented the eighth time that the Dow has reached a 45% decline from a prior peak. In the first seven cases, the index was always higher after 24 weeks, with the gains ranging between 19% and 42%.
- During secular bear markets, cyclical recoveries in the Dow have lasted a median time of 22.5 months, with an average gain of over 60%¹.

¹ - In our judgment, and where noted, it is appropriate for some calculations and conclusions to exclude periods from the Great Depression as data from the period can be considered statistical outliers. Nonetheless, comparisons from the Depression are included in all graphical representations.

INTRODUCTION

Recession or expansion? Inflation or deflation? Capitalism or socialism? What does tomorrow have in store? It has been decades since investors have faced so much uncertainty about the future.

An optimist might argue that the rapid decline in interest rates during the past year, massive funding from government bailouts, and future stimulus programs are all certain to give the economy a needed boost to overcome the recession in 2009. Productivity – the best gauge of long-term economic health – continues to be strong. A proper perspective is that recessions are simply a form of creative destruction causing weak competitors to fail, fraud to be exposed, and leverage to be reduced. Capitalism and free markets are again sowing the seeds of prosperity, so the future is bright.

On the other hand, economies around the world face unprecedented challenges. The financial crisis has added trillions of dollars in additional U.S. government liabilities to an already heavy debt burden. Furthermore, the global financial system has been permanently altered and the market for securitized debt, an important source of capital for business and consumer credit, has been shut down. More problems will result from the growing population of retirees, as underfunded healthcare

and social security obligations loom large. The Western World is still dependent on Middle Eastern oil. So maybe the future is bleak.

Bulls vs. Bears - who will prevail? We think the answer is both. Consequently, investors should prepare for a cyclical bull rally in the ongoing secular bear market.

ANALYSIS

Figure 1 indicates that investors are now experiencing the fourth secular bear market since the inception of the Dow Jones Index. While secular bull and bear markets are typically defined by historic trading ranges, social & geopolitical events also help shape the environments. Secular bull markets occur during times of optimism, peace & prosperity, while secular bear periods are full of stress, turmoil & political change.

Notable milestones during secular bull markets include: The Roaring 20s; Charles Lindbergh flight in 1927; Baby boom (1946-54); Transistor invented 1947; 1950s Rise of the middle class, suburbs & bedroom communities; Salk polio vaccine 1953; 1961-63 Kennedy presidency (Age of Camelot); 1995 Netscape IPO (public adoption of Internet).

Figure 1. Dow Jones Industrial Average

From inception on 26.May.1896 until 30.Nov.2008, daily data

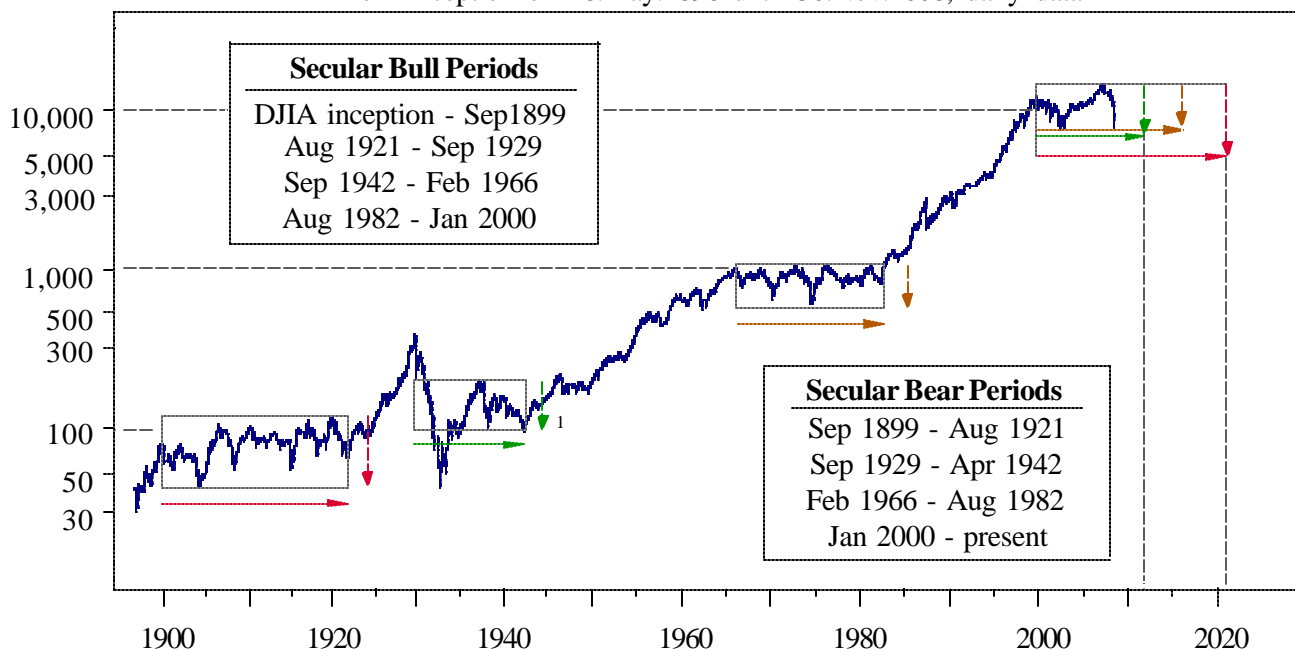


Figure 2. DJIA in Secular Bull Markets¹

Index value excluding bear-market periods
logarithmic scale, 05/1896-11/2008, daily

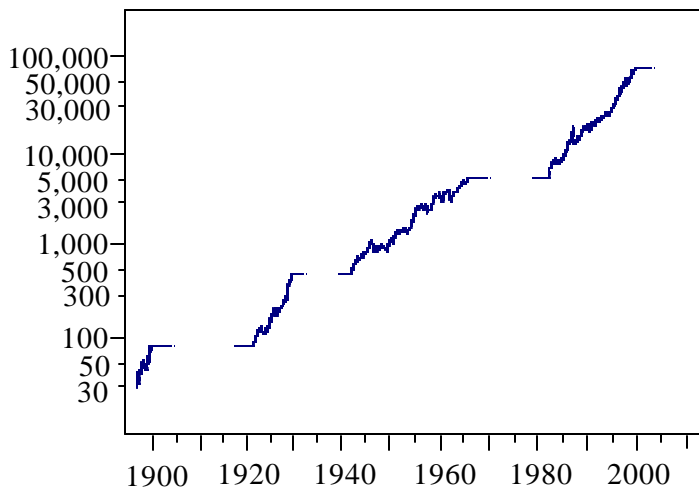
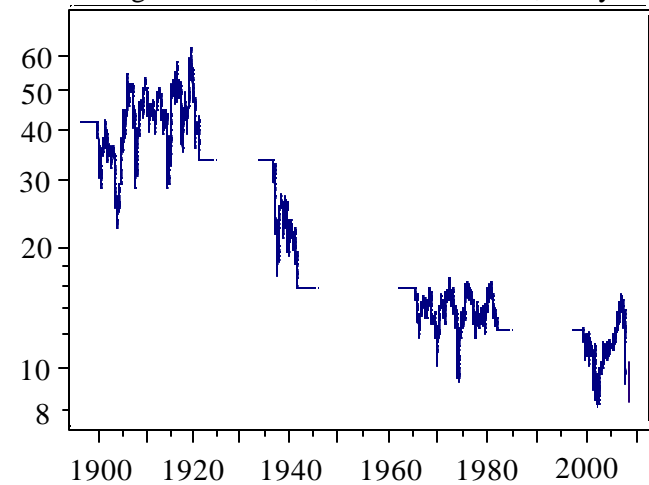


Figure 3. DJIA in Secular Bear Markets¹

Index value excluding bull-market periods
logarithmic scale, 05/1896-11/2008, daily



Likewise, important events during secular bear markets include: President McKinley assassination 1901; WWI 1914-18; Women's Suffrage Amendment (granting women right to vote) 1920; Great Depression 1929-34; WWII 1939-45; Vietnam War 1964-75; Civil Rights Act 1968 (prohibits discrimination in housing); Watergate 1974; Dotcom bubble collapse 2000; Iraq War 2003-present; Housing bubble collapse 2008; First African American president 2008.

Figures 2 & 3 graphically demonstrate the striking difference in stock-market returns in each kind of environment. From a starting value of 40 in 1896, the Dow would be over 70,000 today if trading had been halted during secular bear periods. Likewise, if the Dow excluded the bullish periods, it would trade below 10 today! An important conclusion is that passive buy-and-hold investment strategies are only successful during secular bull markets.

Duration & Depth

As illustrated in *Figure 1*, translating past parameters regarding duration of trading ranges and the depth of market declines indicate the present

bear market should end between 2012 and 2021, with a worst-case downside target of approximately 5,000 for the Dow. A curious feature of the Dow's trading history is the psychology pertaining to round numbers. During the 1900-1920 period, the Dow continually topped out at around 100. In the 1960s and 70s, the barrier was 1,000, and since the year 2000 the index has struggled to permanently surpass the 10,000 mark.

Figure 1 also shows a tendency for the ultimate low to be reached in the first half of the period – a reason to believe that the ultimate low for the current secular bear market might have already been reached in the recent bottom.

Secular bear markets in the 1800s were longer in duration (20-30 years) with wider trading ranges (50%-70% declines from peak to trough). *Figure 1* shows that the extremes moderated in the 20th century. As the economy grew larger and more diverse, fluctuations in the economy and financial markets also moderated over the course of the decades and centuries.

Figure 4. U.S. Economic Growth

Real Gross Domestic Product (GDP) growth
Annualized percent change vs prior quarter

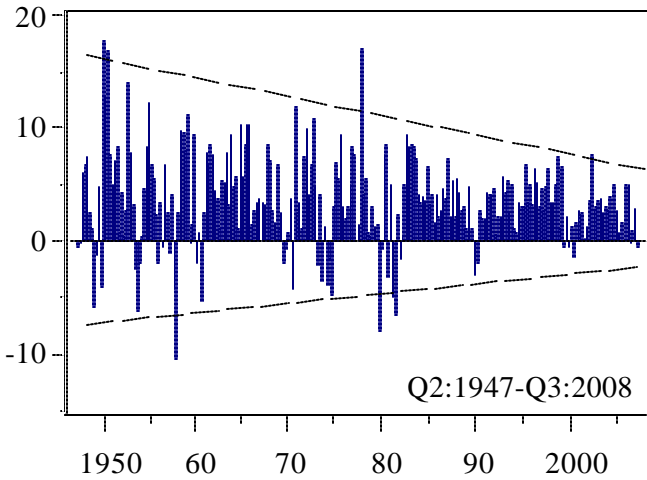
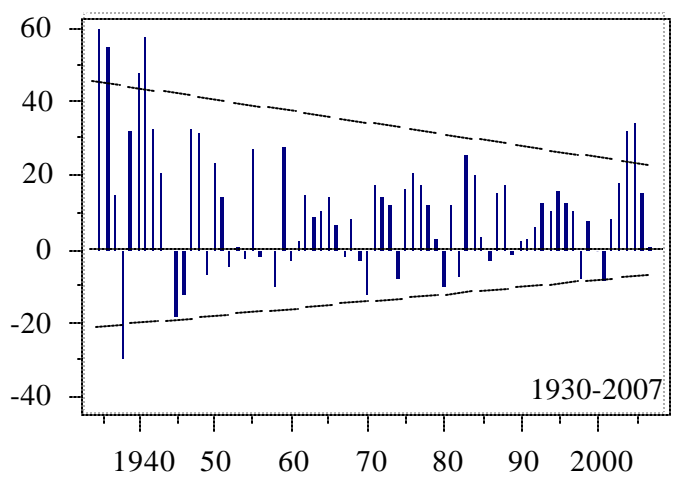


Figure 5. U.S. Corporate Profit Growth

Year-over-year percent change
Yearly data



Source: U.S. Bureau of Economic Analysis

Figures 4 & 5 offer more evidence to support the thesis that today's bear market should not be worse than similar periods from the past. Records from the *U.S. Bureau of Economic Analysis* date back to 1950 for quarterly economic growth, and 1930 for corporate profits. The charts clearly show that volatility in GDP growth and corporate profits has declined, indicating a more stable economy. Consequently, it makes sense that successive bear markets have become less severe over time.

Comparing Past Declines and Recoveries

While it might seem hard to believe, secular bear markets are not particularly unusual. During the entire history of the Dow, 48% of the time has been spent in a secular bear environment. Furthermore, 68% of all recession months occurred during these periods, indicating that recessions are more frequent than otherwise. **Figure 6** highlights the cyclical peaks and troughs in secular bear markets. Most, but not all, cyclical market declines were

Figure 6. DJIA Cyclical Trends in Secular Bear Markets

From inception on 26.May.1896 until 30.Nov.2008, daily data

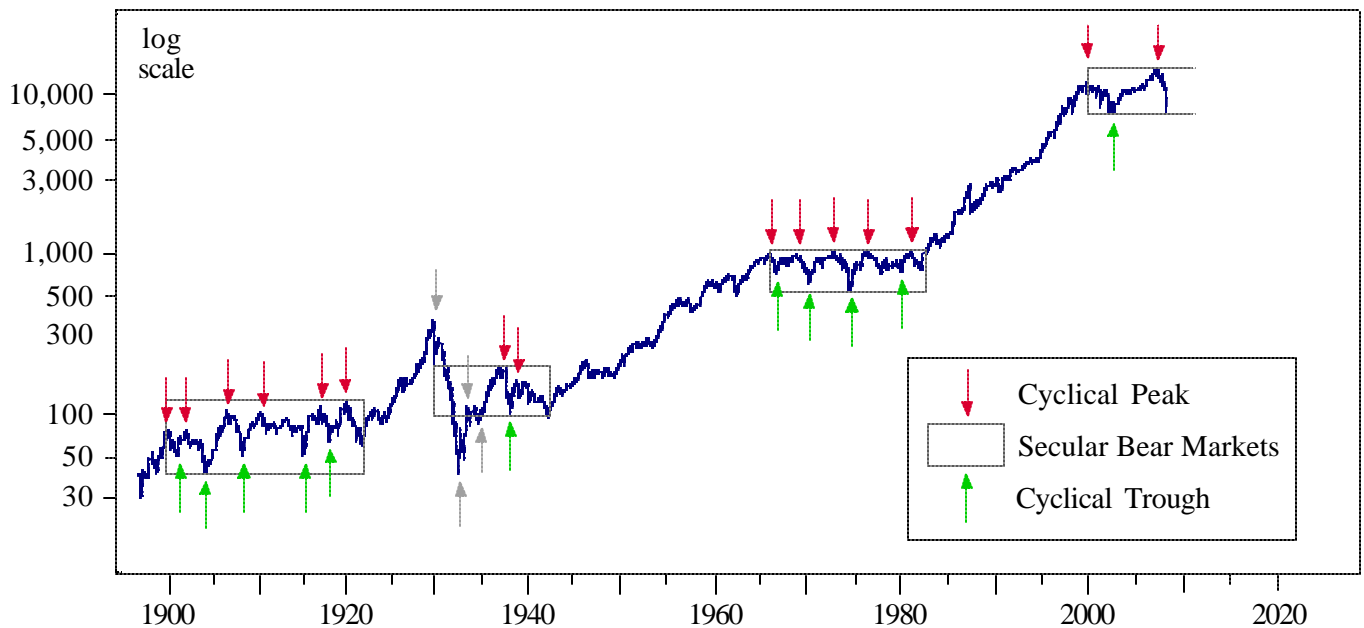
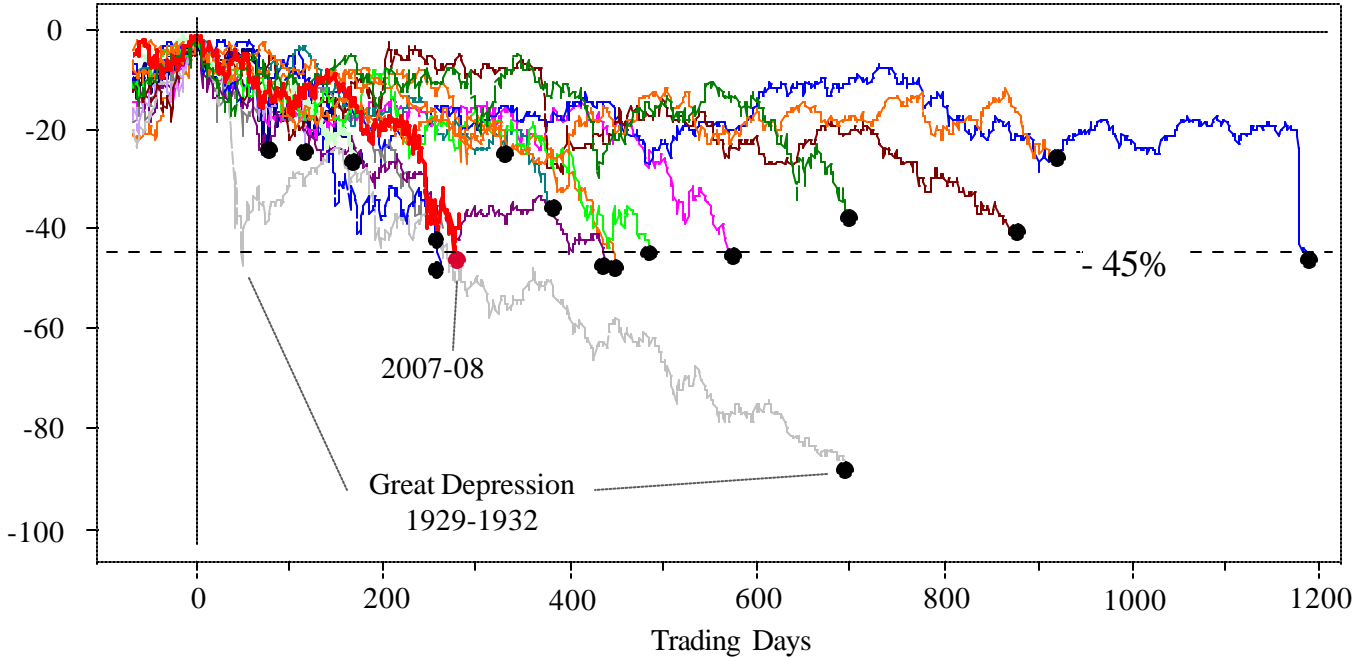


Figure 7. DJIA Bear Market Declines

Cyclical bear market declines during secular bear market periods, percent decline from peak to trough



associated with an economic recession. The cyclical trends highlighted in *Figure 6* are the focus of *Figures 7, 8 & 9*.

As shown in *Figure 7*, cyclical downturns rarely exceed 45%. Historically, every time the peak-to-trough loss reached 45%, a subsequent market rally

followed within 10 trading days. After 120 trading days (24 weeks), the recovery ranged from 19% to 42% above the prior low, as shown in *Figure 8*. Even during the Depression-related bear market, a rally of approximately 30% occurred after the Dow reached a 45% loss from its peak, though the market eventually declined further, reaching a loss of over

Figure 8. DJIA Performance Following 45% Declines

Trading Day set to zero when drawdown reaches -45%, Percent return from Trading Day 0, 05/1895-11/2008

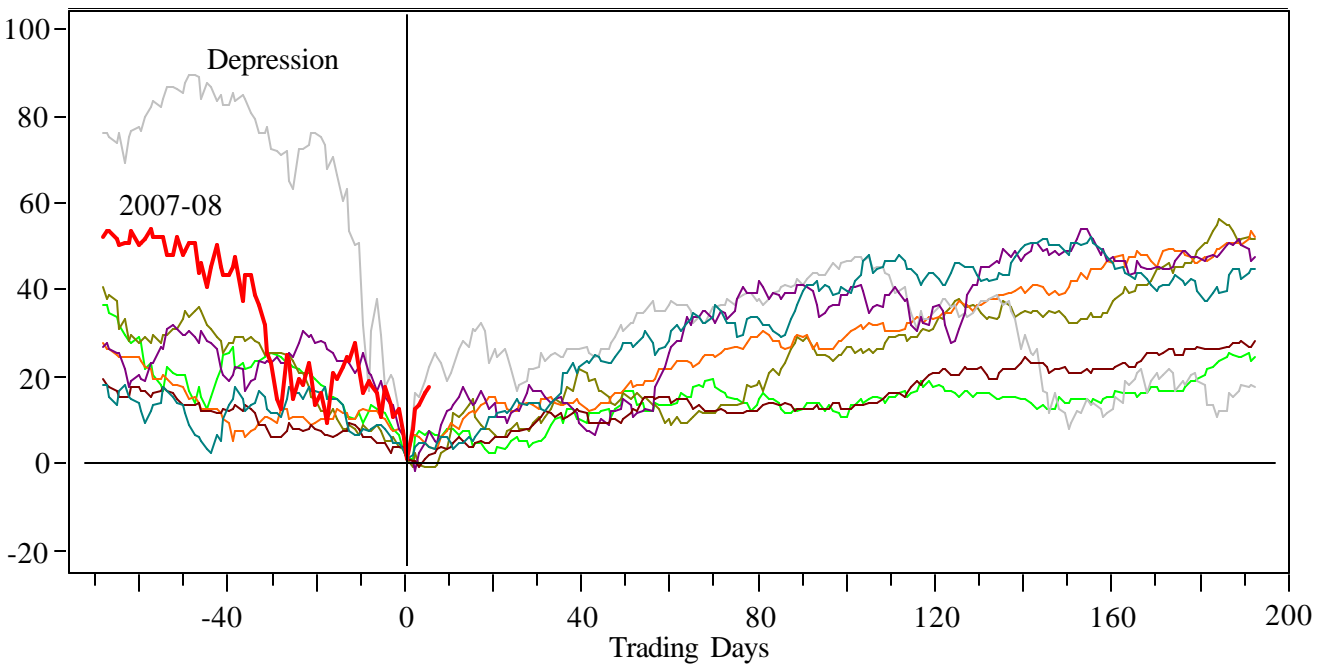
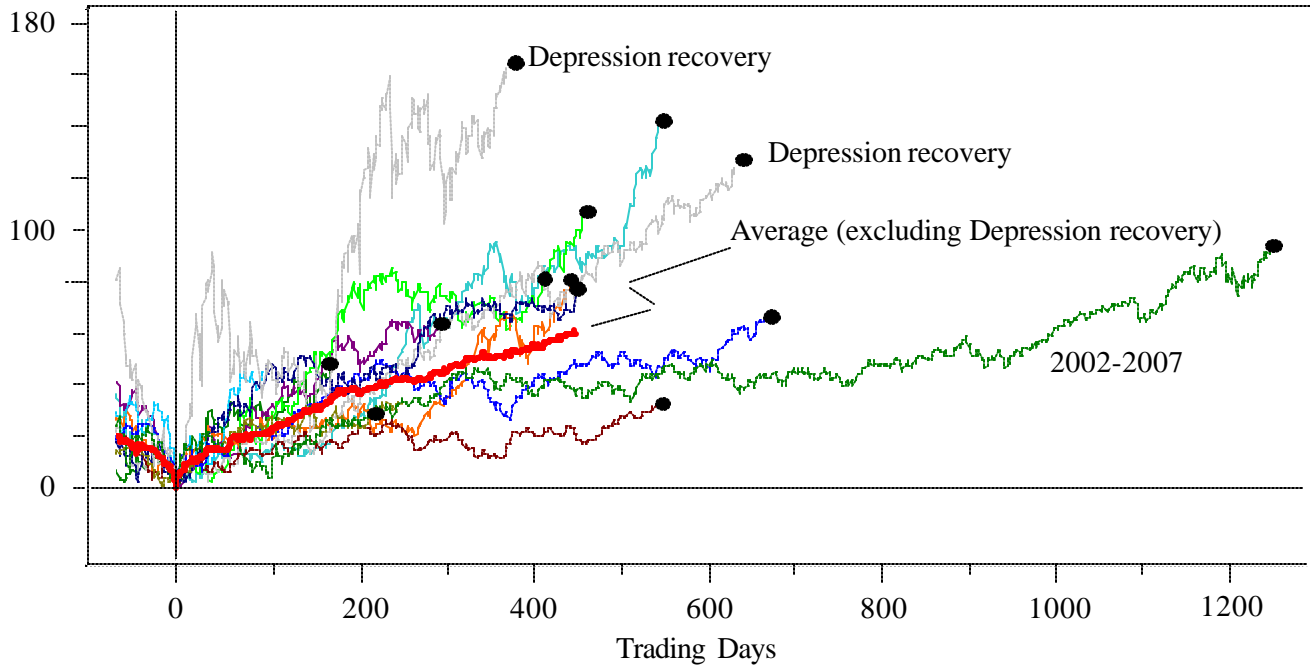


Figure 9. DJIA Cyclical Rallies in Secular Bear Markets

Percent performance from trough to peak during all secular bear markets from 05/1896-11/2008



80% before the ultimate bottom occurred. In the current decline, the Dow reached -45% on November 20, 2008 in near-record time of less than 300 trading days from the prior peak (*Figure 7*). However, the economic expansion from 2002-2007 and associated market rally lasted more than twice the average time during secular bear markets (*Figure 9*). So, perhaps a rapid decline was justified in order to move the current cycle back in line with historic norms.

Opportunities for investment profit still exist in a secular bear market. However, it is very stressful to attempt to sell at the top of a trading range and buy at the bottom. *Figure 9* shows all of the

Dow cyclical rallies during secular bear markets. Historically, market recoveries have lasted approximately 470 trading days (median of 22.5 months), and produced an average gain of over 60%. Assuming the closing low of 7552 on November 20, 2008 represents the low for this economic cycle, the averages from history translate into a peak Dow reading of approximately 12,000 by September, 2010. While there is no reason to expect a recovery to follow history with such precision, these targets represent useful guidelines for future stock market performance.

REFERENCES

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