

Anatomy of a Bear Market Bottom

Market Commentary August 26th, 2002 - Randy McGill, Branch Manager/Owner

In my last letter to you dated July 26, I stated my belief that “evidence is accumulating that we are nearing the end of this bear market cycle. In fact, history tells us that the bottom of a bear market is almost always characterized by several things. They include: the rise of bearish sentiment, tremendous volatility, high trading volume, and even the best stocks dropping in value.” And I answered the rhetorical question “... is the selling over?” “Again, on a short-term basis, I simply cannot know for sure, although for all the aforementioned reasons, I feel very strongly that we are getting close.”

Your July statements reflected the severe declines of the month while your August statements should reflect considerable improvement if the rally of the past few weeks holds until the end of the month. Indeed, the market has improved significantly through August 22nd, with the DJIA (an unmanaged index of 30 widely held stocks), S&P 500 (an unmanaged index of 500 of the largest U.S. stocks) and the NASDAQ (an unmanaged index of mostly smaller stocks) all rallying approximately 20% off their respective lows.

Will the recent rally hold? And is the selling *finally* over? At the risk of disappointing you, I have to answer that I don't think so. Why? For the answers, again we must look to history. And what history tells us is that we must distinguish between a “bear market low” – the lowest price point of a bear market and a “bear market bottom” - a “process” that prepares the market to reenter a bull phase. According to Ralph Bloch, Raymond James Chief Market Analyst and frequent guest on CNBC, “A low is a function of price only, a starting point for a rally & the beginning of a bottom building process. A bottom is a function of price & time and a level from which a multi-week up trend can begin. Since it starts as a counter-trend move, it is a process, not a one-day event.”

So what does this “bottom-building process” look like? Ralph Bloch and his team went back to 1949 and studied nine bear markets/corrections and found a distinct pattern that he calls a “Low-Rally-Retest” sequence. This sequence of events took anywhere from one to five months to play out (an average of 2.33 months) and consisted of an average percentage decline of 27%, an initial rally of 12% off the lows, and a retest that in every case but two (1973-1974 and 1981-1982) held above the initial decline's low. In the case of the two exceptions, the retest undercut the initial low by only one and two percent, respectively.

As far as the current bear market is concerned, it appears that we may have put in a very sharp, high-volume, intra-day price low Wednesday, July 24th. Since that time, the markets have rallied approximately 20% across the board (as mentioned above). If this market follows the historical pattern, the missing ingredient at this point would be a retest of the July lows. Again, looking to history, this retest would occur an average of 2.66 months after the initial low. That would put us roughly in the late September to early October period. Coincidentally (or not?), tax-loss selling and mutual fund restructuring tend to make late September a weak period for stock prices. Finally, the period from May to October tends to be a weak period for stocks in general, while the period from November to April tends to be a strong period for stocks, historically.

If this scenario plays out, what should we do now? Well, in the meantime, the market is likely to trade in a more narrowly defined range than the recently established 7500 to 9000 (DJIA). Considerable overhead resistance (supply) exists in the 9000 area while several “pockets of support” exist above 7500. Trading this range can be tricky, however, not to mention that we are relying on theory and historical averages here... not fact. And of course, the portfolios we design are highly diversified, i.e., they are not designed for trading. So once again, I'm afraid, the watchword is *patience*.

My personal belief is that several important things may be accomplished in the next six weeks or so. I believe, for example, that this period will give our country time to digest the anniversary of September 11th, our economy

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more time to move toward full recovery, and investors more time to digest all of the issues we have dealt with this year. I also believe that a retest of the July lows will present one more opportunity for the uninformed investor to “bail out” of the market, thus once again, creating a buying opportunity for the savvy investor.

Obviously, I want my clients to be on the right side of this last point. In other words, I believe that further declines from here or a retest of the July lows should be viewed as opportunities to add to positions that have been beaten up, but that otherwise have long-term viability – such as well-diversified positions in the technology area. In lieu of this strategy, I believe that, at a minimum, you should remain invested through any retest of the July lows.

Finally, some might ask why we simply don't sit this period out by taking all of our money to cash. Again, I must remind you that we are not dealing with facts here but rather with historical patterns - to be used as guidelines only. Again, none of us can predict the future. And the consequences of “being late to the party” – missing the initial phase of a market rebound - are severe. Consider, for example, a recent study of the bear market of 1973-1974 published by Lazard Asset Management. The study demonstrated that the S&P 500 Index (on a cumulative return basis) recouped its entire decline of 43% twenty-one months after its bottom in September 1974. Going to cash at the bottom of the market and getting back in only six months later, however, the breakeven point was extended by three and one half years! Again, fully invested, the S&P 500 Index was back to breakeven by June of 1976 whereas sitting in cash for six months and reentering the market when it was “safe” (March 1975), delayed the breakeven point until January of 1980!

The lessons of history are clear. Build a portfolio that is consistent with your risk tolerance and your time horizon. Diversify, remain patient and stay the course. Do not get caught up in the hysteria promoted by the news media and others who would profit from your distress. For comfort, turn to your financial advisor(s) for a rational perspective.

Finally, although past performance is no guarantee of future results, I firmly believe that history and recent market action suggest that we are nearing the end of this most difficult period in the stock market. Until that time, my staff and I remain here to comfort you and to assist you with any questions you might have.

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