Weekly Market Commentary

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Unhappy Anniversary

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Highlights

More than half of the declines associated with recessions and bear markets since WWII ended in the month of October, earning it the epithet "bear killer".

When we look back at the recessions that took place in the aftermath of crises, the stock market typically posted a gain during the recession.

The turning point for the stock market in past recessions and bear markets was intervention by policy makers in some form.

For this October to be a bear killer, successful implementation of the Treasury plan to stabilize the financial markets must lead to key demonstrable measures of success including participation by private capital, improving liquidity in the money market, and lifting in the price of comparable securities as a result of the price discovery process.

A month ago we wrote that September is a tough month for investors. Historically, the S&P 500 has posted a decline in September, on average. We also noted the tendency for the stock market to go from a *Labor Day Slump to Election Day Jump.* With September's performance far worse than just a slump with a loss of 9% for the S&P 500, what does October hold as we head into the week that marks the bear market's one year anniversary? The S&P 500 made its all time high last year on October 9, 2007.

Often called the "bear killer" by market historians, October has frequently been the month that the market bottomed and began to rebound. More than half of the declines associated with recessions and bear markets since WWII ended in the month of October. Another way to look at it is that October is the month that has most often marked the start of bull markets. Several drivers must come together if this October is to be a bear killer.

Last Monday's stunning defeat of a bill that would ease the sudden seize-up of the short-term funding markets by providing the Treasury with $700 billion to buy distressed securities shocked the markets. The S&P 500 plunged by the most since the crash of "Black Monday" October 19, 1987, dropping nearly $1 trillion in market value. Although the bill was finally passed and signed into law on Friday, concerns over the extent of the damage to the economy from the seize-up, the additional delay until the plan can be implemented, and how many more financial firms may fail kept stocks from sustaining a rebound. We continue to believe a sustainable rally may only come after the plan is implemented and key measures of success are demonstrated.

The Treasury will implement this plan by buying currently illiquid securities from financial institutions at a liquid market price through a reverse auction. Participants in the auction would offer to sell their otherwise illiquid securities to the Treasury. This procedure has several benefits:

- Financial institutions will be able to sell their hard to price assets and shore up their balance sheets, restoring confidence and liquidity to the financial markets.
- The Treasury and the taxpayer may experience gains from the program, since the Treasury can sell these securities over time or hold them to maturity, receiving the real economic value for the debt rather than having to sell them all at once at fire sale prices.
- The government, as holders of these loans and securities, can work with borrowers to reduce foreclosures and modify loan terms, reducing the stress on homeowners.

The process is likely to entail some experimentation. The Treasury is likely conduct a process where financial institutions will bid to sell their illiquid assets to the Treasury. The Treasury will announce its intention to buy a certain percentage of the amount outstanding of a security and solicit sellers at a relatively high initial offering price, then dropping the offering price incrementally until the institutions are willing to sell only the percentage the Treasury is willing to buy. Those that sell the security to the Treasury will receive cash. The others who were unwilling to sell at the offered price would reflect the new liquidity–based market price for the security on their books, which would likely improve the condition of their balance sheet. The securities will be managed by a group of private firms who will only sell them on behalf of the Treasury after markets have normalized.

Now that the bill has become law, we expect managers will be hired and the reverse auction program will begin within a few weeks. After the auction begins, along with complementary actions by the Federal Reserve, we expect to see participation by private capital, improving liquidity in the money market, and lifting in the price of comparable securities as a result of the Treasury's price discovery process. These will be signs that this cure for the crisis is working and averting catastrophe in the form of a prolonged and deep recession.

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In the meantime, every day the implementation is delayed, the seizure of the credit markets becomes more dire for economic and earnings growth. There are growing signs of economic stress as the economy appears to be entering a recession. Last week's weak data on September manufacturing activity and employment are harbingers of even weaker data over the coming months as the impact of the sudden intensification of the financial crisis in September is broadly felt outside of the financial sector.

There is some good news; when we look back at the recessions that took place in the aftermath of crises, the stock market typically posted a gain during the recession. For example, the aftermath of the bitter medicine of rate hikes that ended the inflation crisis of the late 1970s and early 1980s resulted in the longest recession since the Great Depression. During the 16 months of recession from July 1981 to November 1982, the S&P 500 posted a 14% total return. Another recession followed the late 1980s and early 1990s Savings & Loan crisis, during which over 1,000 U.S. financial institutions failed, primarily as a result of imprudent real estate lending. During this eight month recession, from July 1990 to March 1991, the S&P 500 generated an 8% total return.

The nearby table includes the performance of the S&P 500 during every recession and bear market since WWII. As you can see, stocks have always bottomed before the recession was over—typically around the halfway point—and delivered on average powerful 25% gains, recouping nearly all losses by the end of the recession. If the U.S. experiences a recession lasting six to nine months, with a decline in GDP in the third and fourth quarters perhaps lingering into the first quarter of 2009, then we may be near the halfway point of this recession, the point at which these previous markets have typically rebounded.

The underlying driver that triggered these rebounds and limited the duration of the recessions and bear markets was intervention by policy makers in some form, as we can see looking back over the past 35 years.

S&P 500 PERFORMANCE DURING RECESSIONS AND BEAR MARKETS SINCE WWII

S&P 500 Peak	S&P 500 Trough	Total Decline	Recession?	Length of Recession in Months	Months from S&P 500 Trough to End of Recession	S&P 500 Gain from Trough to End of Recession
6/15/48	6/13/49	-21%	Yes	11	5	+18%
2/2/53	9/14/53	-14%	Yes	10	9	+28%
7/15/57	10/22/57	-21%	Yes	8	6	+11%
8/3/59	10/25/60	-14%	Yes	10	4	+21%
12/12/61	6/26/62	-28%	No	-	-	-
2/9/66	10/7/66	-22%	No	-	-	-
11/29/68	5/26/70	-36%	Yes	11	6	+26%
1/11/73	10/3/74	-48%	Yes	14	6	+34%
9/21/76	3/6/78	-19%	No	-	-	-
2/13/80	3/27/80	-17%	Yes	6	4	+24%
11/28/80	8/12/82	-27%	Yes	16	4	+35%
8/25/87	10/19/87	-33%	No	-	-	-
7/16/90	10/11/90	-20%	Yes	8	6	+29%
7/17/98	10/8/98	-19%	No	-	-	-
3/24/00	10/9/02	-49%*	Yes*	8	*	*
Average ex-2002		**-24%**		**10**	**5**	**25%**
10/9/07	*Current*	*-30%*	*Yes*			

Source: Bloomberg and the National Bureau of Economic Research, LPL Financial

* This recession ended in November of 2001 – from the low point during the recession (9/21/01) until the end of the recession stocks were up 18%, but stocks fell again in late spring of 2002 as the accounting scandals renewed the market decline culminating a 49% total decline for the entire two and a half year bear market.

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- The Federal Reserve's rate cuts and active intervention during the failure of hedge fund Long Term Capital Management, due largely to bad investments in the debt of emerging market countries, led to the end of the 1998 bear market.
- In October of 1990, after a tripling of oil prices due to Iraq's invasion of Kuwait, oil prices finally began to recede as stepped up production by OPEC and non-OPEC members ensured oil supplies remained sufficient. The Fed also began to cut rates aggressively starting in October of 1990. These factors marked the turning point for the 1990 bear market.
- An FDIC takeover and the Fed rate cuts that followed one of the largest bank failures in history helped to end the long November 1980-August 1982 bear market. Penn Square bank was taken over by the FDIC in July of 1982 after its failure resulting from bad loans made during the oil boom of the late 1970s and early 1980s.
- The Fed cut rates substantially beginning in March of 1980 ending the market decline, as inflation finally began to fall after peaking in that month at a 14.8% year-over-year pace, reversing a series of rate hikes that had taken the Federal Funds rate to 20%.

- Fed rate cuts of 375 basis points helped to put a close to the 1973-74 bear market. The cuts coincided with the October 1974 failure of Franklin National Bank, which was at that point the biggest bank failure of all time. Closure of the issues surrounding Watergate also helped this recovery.

The Treasury plan to buy distressed debt, combined with the actions of the Federal Reserve to lower the effective Federal Funds rate to below 1% last week, may constitute the policy intervention required to mark the trough for the current bear market and begin the healing process for the economy. If so, the duration of the recession may be limited to another three to six months. However, if the frozen credit markets prove more difficult to thaw, the recession could extend beyond early 2009 and may deepen, bringing the decline in corporate earnings beyond the 20% cut to analysts' current 2009 earnings per share estimates that we now expect. We will be able to gauge the degree of success of the Treasury plan over the coming weeks.

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