



Weekly Market Commentary



October 20, 2008

Relief and Retest

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Highlights

A key sign that the crisis began to ease last week was the decline in the LIBOR, reflecting firms becoming less reluctant to part with their cash. Stocks posted a 5%, as measured by the S&P 500 Index, gain during a volatile week as the LIBOR fell every day in response to policy initiatives.

While the stock market may have bottomed on October 10, bear markets of this magnitude nearly always (10 of 11 times) pull back after an initial rally. This “retest” is often the result of lingering uncertainty over the potentially negative unintended consequences of policy actions, in addition to a reassessment of the depth and duration of the recession.

On average, the relief rallies following bear markets lasted three months and resulted in the S&P 500 rebounding to (or close to) its 50 day moving average in nearly every case. The current 50 day moving average is at about 1200 on the S&P 500, substantially above the current level of 940.

The election calendar, seasonality, and history of bear markets all point to an October bottom for the stock market. In election years, October often marks the start of the rally after a volatile first three quarters of the year. Since the start of the S&P 500 in the 1920s, the fourth quarter of a Presidential election year has always posted a gain with only two exceptions, 2000 and 1932. Often called the “bear killer” by market historians, more than half of the declines associated with recessions and bear markets since WWII ended in the month of October. The market plunge in September and October was dramatic, and it became deeply oversold on a technical basis and very undervalued on a fundamental basis; however, the market needs a trigger to unlock these conditions and begin a rally.

In last week’s commentary, we noted that as the crisis begins to ease, the first sign will be firms becoming less reluctant to part with their cash. Prior to last week, the spread between the three-month LIBOR, or London interbank offered rate, and the expected federal-funds rate over the next three months had soared. This spread shows the difference between what firms charge each other for short-term cash and what they expect to pay in the relatively risk-free overnight fed-funds market. After averaging 100 basis points for much of this year, the spread suddenly tripled in September to about 300 basis points, indicating a major financial crisis had erupted. This spread widened further in October and peaked at about 450 basis points on October 10. And as we also noted last week, as the LIBOR begins to fall, stocks are likely to rally as the crisis begins to fade. Indeed, stocks did post a 5% gain during a volatile week as LIBOR fell every day in response to policy initiatives.

Examining every recession and bear market since WWII reveals that stocks have always bottomed before the recession was over and delivered on average powerful 25% gains, as measured by the S&P 500 Index, recouping nearly all losses by the end of the recession. 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—often the FDIC is forced to intervene and take over a large bank and the Fed cuts interest rates aggressively to provide liquidity to the financial system. The Treasury plan to buy distressed debt and preferred stock from financial institutions, combined with the actions of the Federal Reserve, may constitute the policy intervention required to mark the trough for the current bear market and begin the slow healing process for the economy.

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1 Key Gauge of Crisis Shows Signs of Easing 3 month U.S. LIBOR Less 3 Month Treasury Bill Yield



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S&P 500 DURING BEAR MARKETS SINCE 1950

Bear Market Low	Peak to Trough Decline	Retest?	Retest Low	Months from Initial Low to Retest	Did Relief Rally Reach 50 Day Moving Average?
10/22/57	-21%	Yes	12/18/57	2	Yes
6/26/62	-28%	Yes	10/23/62	4	Yes
10/7/66	-21%	Yes	10/7/66*	1	Close
5/26/70	-36%	Yes	7/7/70	1	Close
10/3/74	-48%	Yes	12/6/74	2	Yes
3/6/78	-19%	Yes	11/14/78	8	Yes
8/12/82	-27%	No	-	-	-
10/19/87	-33%	Yes	12/4/87*	2	No
10/11/90	-20%	Yes	10/11/90*	2	Close
10/8/98	19%	Yes	10/11/90*	2	Close
10/9/02	-49%	Yes	3/11/03	6	Yes
Average	-29%	Yes		3	Yes/Close

*In 1966, 1987, and 1990 the retest low was lower than the initial low (by 1.8%, 0.4%, and 3.7%).

Source: LPL Financial, Bloomberg
Past Performance is no guarantee of future results.

Of the bear markets since 1950, 10 of 11 retested. Only after the August 1982 low of the long bear market and recession did the stock market move steadily higher without retesting the low. Retests do not always revisit the prior low, but result in a pullback of at least 50% of the relief rally that followed the low point for the bear market. Some of the retests actually had a lower low than the initial low (but only by a percent or so), but using breadth and volume indicators we can see that the initial low that we defined in the table was truly the bottom. For example in 1987, when October clearly marked the low, stocks went on to retest in December with a low that was less than one percent below the “Black Monday” low of October 19, 1987.

The relief rallies were all a little different, but the time until retest averaged three months. Nearly every case resulted in the S&P 500 rebounding to (or close to) its 50 day moving average before peaking out. The current 50 day moving average is at about 1200 on the S&P 500, substantially above the current level of 940. The only relief rally that failed to get anywhere near the 50 day moving average took place in 1987, when the S&P 500 rallied 15% in the few days following the low, but could not reach a lofty 50 day moving average—the index had been boosted by a 40% rally in the first half of that year followed by a sharp plunge over just a few days. The sharpness of the recent decline echoes that of 1987, but other conditions are very different.

- Back in 1987, the S&P 500 had soared just before the declines. In 2008, stocks had already slumped leading into the steep decline that began in September.
- In 1987, the Federal Reserve was hiking interest rates in the months leading up to the crash. In 2008, the Fed was cutting interest rates.
- In 1987, the plunging dollar was a driver of the declines. The dollar has been rising in 2008, leading up to and during the recent declines.
- In 1987, market participants suddenly faced the potential of a recession



(which did not occur) after the market crashed, and that helped to cap the relief rally. In 2008, the likely recession had been priced in to the market well ahead of the declines in September and October that stemmed from the credit seizure.

Retests happen for a variety of reasons, but given the uncertainty and unintended consequences of recent policy actions to address the financial crisis, it seems logical that a retest will follow any relief rally over the coming months. The improving but volatile environment for stocks suggests investors may want to seek the types of alternative investments that benefit from high market volatility, such as global macro funds and covered call strategies, which may be increasingly effective at managing risk and return.

IMPORTANT DISCLOSURES

Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal. Past performance is not a guarantee of future results.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise and are subject to availability and change in price.

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