

## Anatomy of a "Great" Bear Market

After February's equity market plunge, the sharp March rebound, and more echoes of the Great Depression reverberating in the news, we thought it worthwhile to provide some historical perspective on the current bear market. To help you frame your investment planning and asset allocation strategy, we include a comparison of the today's economic context to that of the 1929-32 era.

As shown below, excluding the current bear market, there have been 15 bear markets with peak-to-trough losses of more than 10% since 1926. The duration of the current bear, at 16 months through the February low, is longer than all but five measured from peak to trough. In terms of percentage loss peak-to-trough, the current market is worse than all but the 1929-32 period.

| U.S. Equity Bear Markets - Losses Greater than 10% from Peak |                       |         |                |                  |                |              |                |
|--|-----------------------|---------|----------------|------------------|----------------|--------------|----------------|
| #  | Dates                 |         | Return to Peak | Number of Months |                |              | Max Loss%      |
|  | Peak                  | Trough  |                | Peak to Trough   | Trough to Peak | Peak to Peak |                |
| 1  | Aug-29                | Jun-32  | Jan-45         | 34               | 151            | 185          | -83.4%         |
| 2  | Feb-37                | Mar-38  | Mar-44         | 13               | 72             | 85           | -50.0%         |
| 3  | May-46                | Nov-46  | Oct-49         | 6                | 35             | 41           | -21.8%         |
| 4  | Jul-56                | Feb-57  | Jul-57         | 7                | 5              | 12           | -10.2%         |
| 5  | Jul-57                | Dec-57  | Jul-58         | 5                | 7              | 12           | -15.0%         |
| 6  | Dec-61                | Jun-62  | Apr-63         | 6                | 10             | 16           | -22.3%         |
| 7  | Jan-66                | Sep-66  | Mar-67         | 8                | 6              | 14           | -15.6%         |
| 8  | Nov-68                | Jun-70  | Mar-71         | 19               | 9              | 28           | -29.2%         |
| 9  | Dec-72                | Sep-74  | Jun-76         | 21               | 21             | 42           | -42.6%         |
| 10   | Dec-76                | Feb-78  | Jul-78         | 14               | 5              | 19           | -14.1%         |
| 11   | Nov-80                | Jul-82  | Oct-82         | 20               | 3              | 23           | -16.9%         |
| 12   | Aug-87                | Nov-87  | May-89         | 3                | 18             | 21           | -29.5%         |
| 13   | May-90                | Oct-90  | Feb-91         | 5                | 4              | 9            | -14.7%         |
| 14   | Jun-98                | Aug-98  | Nov-98         | 2                | 3              | 5            | -15.4%         |
| 15   | Aug-00                | Sep-02  | Oct-06         | 25               | 49             | 74           | -44.7%         |
| Current  | Oct-07                | Feb-09? |                | 16 to date       |                |              | -50.9% to date |
|  | Average (1 - 15)      |         |                | 12.5             | 26.5           | 39.1         | -28.4%         |
|  | Average (1,2, 8 & 15) |         |                | 23.3             | 73.3           | 96.5         | -55.2%         |

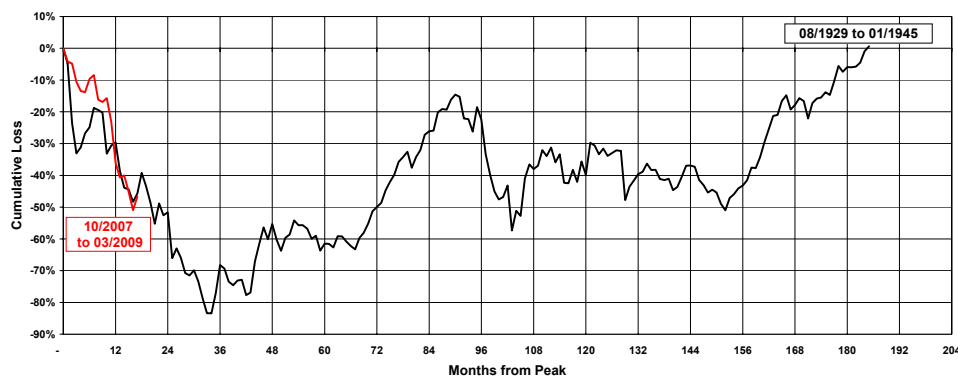
Max Loss% and occurrences calculated from prior peak. Data through February 2009. Sources: Bloomberg, Ibbotson, FDX Advisors

\*\*\* Bear Market #2 is technically a subset of the depression era bear market. It occurred after a 415% cumulative return from the

June 1932 low to a Feb 1937 high. Other declines greater than 10% occurred during the 1932-1945 period. This one is included in the table as the most severe bear market that occurred between the 1932 low and the 1945 return-to-peak interval of the depression era.

The timeline analysis below shows that the current bear market from the October 2007 peak is actually worse than the decline from the August 1929 peak thus far.

Current Bear Market vs 1929



So, even after the strong March rally, the market is pricing an economic scenario similar to, or perhaps worse than, the Great Depression

**Is this bear market performance justified by current economic performance and policies? The short answer is “No.”** Let’s see how the situation today compares with the 1929-32 era:

| Measure            | 1930   | 2008 | Difference |
|--------------------|--------|------|------------|
| Real GDP Growth    | -8.6%  | 1.1% | 9.7%       |
| Nominal GDP Growth | -12.0% | 3.3% | 15.3%      |
| Inflation Rate     | -3.7%  | 2.2% | 5.8%       |
| Unemployment Rate  | 8.7%   | 5.8% | -2.9%      |

Source: Bureau of Economic Analysis, FDX Advisors

**Using the first calendar year after the equity market peak, 2008 economic performance trounced 1930.** During 1930, real GDP fell by 8.6%, prices dropped by almost 4% and unemployment averaged 8.7%. In 2008, real GDP rose, prices rose, and unemployment averaged almost 3% less than in 1930.

So far, 2009 unemployment has averaged 8.1% and has been rising sharply. It hit 8.5% in March and may be on its way to 10%. It reached 10.8% in 1982, but averaged a slightly less 9.7% as shown in the table below.

| Calendar Year After: | Aug 29 | Dec 72 | Nov 80 | Aug 00 | Oct-09 |
|----------------------|--------|--------|--------|--------|--------|
| -                    | 3.2%   | 5.6%   | 7.1%   | 4.0%   | 4.6%   |
| 1                    | 8.7%   | 4.9%   | 7.6%   | 4.7%   | 5.8%   |
| 2                    | 15.9%  | 5.6%   | 9.7%   | 5.8%   | 8.1%*  |
| 3                    | 23.6%  | 8.5%   | 9.6%   | 6.0%   |        |
| 4                    | 24.9%  | 7.7%   | 7.5%   | 5.5%   |        |
| 5                    | 21.7%  | 7.1%   | 7.2%   | 5.1%   |        |

\*Average of Jan, Feb and Mar 2009; 7.6%, 8.1%, and 8.5% respectively  
Source: U.S Census, Bureau of Labor Statistics, FDX Advisors

In 1931, which corresponds to 2009 as the second calendar year after the market peak, unemployment averaged 15.9% and hit an average of 24.9% two years later. Unemployment is nowhere close to the levels experienced by our grandparents, nor has it yet reached 1982 levels that some of us experienced first hand.

**This may be like your grandparent’s bear market, but it is not your grandparent’s depression.** To be sure, this is not a typical, cyclical recession. It is compounded by dysfunctional credit markets and a deleveraging of balance sheets.

**The consumer is retrenching and should.** The personal savings rate has risen from zero in April 2008 to 5% in January 2009. This is healthy for our economy in the long-run, but in the near-term, because the consumer is such a large part of our economy, many observers fret that there will be no engine for growth in the U.S. or globally. They are partially right.

We need consumption growth, but not to the extent of the recent past. Over the past 30 years, consumer spending has grown faster than overall GDP, taking its share of GDP from 62% in 1978 to 71% in 2008. During the same period, private investment spending lagged GDP growth and declined from 19% of GDP to 14%. **We need the mix of growth to change to emphasize job creating investment.** Continued excess growth in consumption is not a healthy policy objective.

It may take some by surprise that this problem was more pronounced in 1929. Consumer spending was a larger proportion of the economy then than now. Government spending as a share of GDP in 1929 was less than half the level of 2007, providing less stability for the economy than today. Here are the components of GDP:

| Year        | 1929  | 1930  | 2007  | 2008  |
|-------------|-------|-------|-------|-------|
| Consumption | 74.7% | 76.9% | 70.3% | 70.5% |
| Investment  | 15.9% | 11.8% | 15.4% | 14.0% |
| Government  | 9.1%  | 11.0% | 19.4% | 20.2% |
| Net Exports | 0.4%  | 0.3%  | -5.1% | -4.7% |
| Exports     | 5.7%  | 4.8%  | 12.0% | 13.0% |
| Imports     | 5.4%  | 4.5%  | 17.2% | 17.7% |

Source: Bureau of Economic Analysis, FDX Advisors  
Totals may not sum to 100% due to rounding

Perhaps the most significant differences between today and the 1929-32 era are in the conduct of trade, monetary and fiscal policy. Note that, as nominal GDP fell 12% in 1930, **both trade and investment fell by a whopping 26% and 36% respectively. By 1932, trade had declined by 2/3’s and investment by 92%.** We can thank boneheaded trade, fiscal and monetary policies for this result. Leaders implemented anti-growth policies in the initial years of the depression, exacerbating an already weak economy.

**While our current political leadership has made mistakes and will make more, thus far, they are not repeating the mistakes of 1929-30.** The jury is still out on global trade policies, but monetary and fiscal policies, if anything, are erring in the opposite direction.

**FISCAL POLICY – DEFICIT SPENDING**  
Using the percentage change in Federal debt as the broadest measure of deficit spending, the table below shows fiscal policy then versus now:

|      | Then | Now       |
|------|------|-----------|
| 1929 | -4%  | 2007 6%   |
| 1930 | -4%  | 2008 11%  |
| 1931 | 4%   | 2009F 27% |

Source: U.S. Treasury, whitehouse.gov

In 1929 and 1930, the federal government reduced its debt outstanding by 4% each year – i.e. they ran surpluses. Not the best medicine for stabilizing an economy. The opposite is true today. We will stay out of the debate about how the money is being spent for now and just point out that the current direction of spending is the right one to help stabilize the economy.

### MONETARY POLICY – M2 GROWTH

The Federal Reserve also erred by tightening monetary policy to help cause the depression, a mistake current Fed Chairman Ben Bernanke has studied in detail and is intent on not repeating.

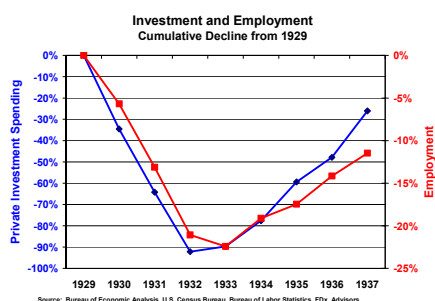
| Money Supply Growth |       |      |       |
|---------------------|-------|------|-------|
| Then                |       | Now  |       |
| 1929                | 0.4%  | 2007 | 5.6%  |
| 1930                | -1.9% | 2008 | 9.9%  |
| 1931                | -6.6% | 2009 | 9.8%* |

\* through February  
Source: Historical Statistics of the United States, the Federal Reserve, Bloomberg

Bernanke has managed to generate significant money growth despite the credit crisis, something he will need to constrain eventually to avoid too much inflation, but for now, avoiding deflation is much more important.

### CREDIT MARKETS ARE THE KEY

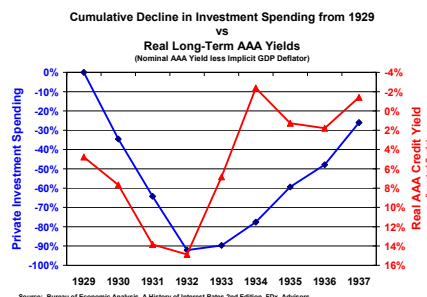
Policy makers are rightly focused on avoiding deflation, fixing the banking system and getting credit markets working again, not just so people will buy things, but to stimulate job creating private investment. During the depression, investment spending collapsed and with it came depression levels of unemployment.



So far, we are not close to repeating the decline in investment that occurred in the Great Depression. Private investment fell by 6.3% in 2008, a decline consistent with other recessions.

The Fed and the White House know they need to facilitate private investment. Bernanke will keep rates low and the Treasury's alphabet soup of programs – TARP, TALF, PPIP, etc. – are all designed to unfreeze credit markets.

A gauge of progress is the *real* cost of borrowing – credit yields less inflation. Here is how real yields led private investment in the depression:



Currently, the *real* cost of borrowing is way too high – over 5% for investment grade debt and more than 16% for high yield debt, based on core inflation which excludes volatile food and energy. Real yields would measure almost 2% more if overall CPI inflation rate were used.

Key items to watch that will drive the real cost of private borrowing are:

1. Actual and expected inflation/deflation
2. The level of credit spreads.

How have they been doing so far?

### INFLATION/DEFLATION

- Core CPI inflation has remained around a 1.8% annual rate for the past three months. Overall inflation fell to zero in January on the collapse in oil prices.
- Inflation/deflation expectations, as measured by 5-year inflation protected Treasuries versus nominal Treasuries, have risen from low of *minus* 0.6% annually at the end of October to a positive 0.9% currently.

They may have staved off deflation for now. A little more inflation, in the 2- 3% range, would cushion against a deflation shock or surprise.

### CREDIT SPREADS

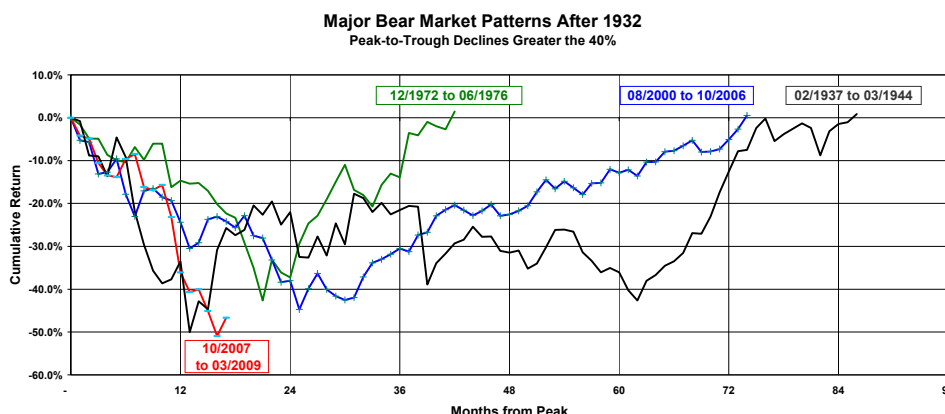
- Investment grade credit spreads, at 4% to 5% over Treasuries depending on maturity, remain way too high. The long-term average is in the 1.1% to 1.2% range.
- High yield bonds had their best performance since the fourth quarter of 2003 as spreads fell by more than 1.5%. A step in the right direction, but spreads, at more than 16% over Treasuries, remain more than 10% above their long-term averages.

So, investment grade credit spreads have stabilized below recent highs, and high yield spreads have started to fall. This is progress, but we need more. We don't need to see investment grade spreads immediately snap back to their long-term averages and they won't. It will take some time. However, barring any significant further shocks or major policy errors such as a trade war, **for investment grade companies, a reduction in the real cost of borrowing to the historical long-term average or below is achievable through a modest rise in core inflation of 0.75%, combined with a similar decline in credit yields.**

**Now, back to the equity market and whether it is a good time to invest.** The answer depends on both your confidence and your horizon. If, despite the evidence, you believe that a repeat of the Great Depression is inevitable, then you will look at the current rally as an opportunity to sell – the market had a similar bounce in 1931 before declining to new lows.

Consider this... a dollar cost averaging strategy, implemented in the decline from Jan-31 through Jun-32 and held through Jan-36, would have about doubled your money over five years. **For those with horizons of five years or longer, even the Great Bear Market offered positive outcomes at this stage in the decline, albeit with quite a bumpy ride.**

Now consider the possibility that this bear market will turn out to be more like other post-1932 bear markets. What do patterns of other post-1932 major bear markets suggest?



The February low looks sharp enough that it *may* be a bottom in price, but we need to see confirmation in credit markets. There is still a lot of work to do in terms of time and there is a lot of volatility ahead. What do returns look like after a 40% decline or more, and a post-1932 assumption? From not bad to very good overall. At a five year horizon, just plain good – 14.3% at the median, worst outcome was 8.3% annualized.

| Post-1932: S&P 500 After Declines of 40% or More |        |         |      |       |
|--|--------|---------|------|-------|
| Annualized Returns (%)                           |        |         |      |       |
| Holding Period (yrs)                             | Median | Average | Best | Worst |
| 1  | 36.6   | 44.3    | 98.7 | 2.9   |
| 2  | 21.7   | 22.3    | 41.5 | 5.1   |
| 3  | 23.7   | 23.5    | 43.3 | 4.3   |
| 4  | 23.5   | 22.0    | 39.9 | 0.1   |
| 5  | 14.3   | 15.2    | 28.9 | 8.2   |

Periods Beginning: June 1932-March 2004. Periods Ending: June 1933-March 2009  
Past performance does not guarantee future results. Source: Ibbotson, MPI, FDXA

Chances are this bear market will end up being viewed as one of the worst, but much better than the depression era market. Making big bets, including all cash, on a one or two year prediction can be detrimental to financial health. **For capital that is needed in less than five years, caution remains appropriate as systemic risks remain. For horizons longer than five years, not participating in this market may mean foregoing significant opportunity to grow assets and achieve longer term goals.** Keys to success include a solid investment plan, the discipline to stay with it, and diversification to manage risk. A dollar cost averaging approach may help you to participate in the market, benefit from episodic declines, and manage emotions.

# ***Important Information and Disclosures***

Sources of information for this report include The Wall Street Journal, The Economist, The New York Times, Bloomberg, Barclays/Lehman, MPI Stylus, Ibbotson U.S. Census Bureau, US Department of Labor, Bureau of Economic Analysis, A History of Interest Rates 2<sup>nd</sup> Edition, Historical Statistics of the United States, The Federal Reserve, whitehouse.gov, and FDx Advisors

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