

Fear and Loathing in the Stock Market

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We continue our chronicle of the Stock Market Cycle with a brief analysis of the recent phase. Chapter 1 was “Panic,” set in the September – October – November 2008 period. Chapter 2 was “Exhaustion,” which played out in January, February and early March of 2009. Now we move on to “Confusion,” the chapter that began on March 10, 2009 and continues through the present. This chapter is marked by the conflict of rising stock prices versus very poor economic conditions.

Historic Returns

In the second quarter of 2009, the S&P 500 recorded its 16th best price gain return out of 325 calendar quarters since our data begins in 1927. Indeed, this has been one of the best periods for equities in our lifetimes. Yet, you won’t hear many champagne corks popping. The wounds from investment losses during the crash are too fresh.

The “still bad, but less bad” economic conditions and lurking long term problems cast doubt on the sustainability of recent stock market gains. However, looking at the list of other “top 20” gains from the S&P Index reminds us that most great gains come during very bad economic periods. The top gain list is dominated by periods from the 1930s, 1975, 1982, 1998 and 2003. Most of these periods were “post crisis rebounds” with gains being recorded during very difficult recessions. History shows that market tops are made in healthy economic times, bottoms are made during bad economic times and the strongest returns to investors occur in the rebounds off the bottom while the economy is still in bad shape. The past few months’ gains are very similar to the past.

Confusion Reigns

In many ways, the stock market’s recent advance seems surreal and we all worry that the rebound could vanish amid the tide of bad economic news. Back in early April, I recall hearing one bearish talking head on TV proclaim, “Until there is evidence of a turnaround in the economy, we must assume that the recent rally is simply a bounce in the ongoing bear market and we will see lower lows in the future.” At the time, there were few signs of hope for improvement. However, this comment belies a naiveté about the forward looking nature of the stock market. By the time that evidence of an economic rebound is visible, the stock market will have already risen in anticipation of the rebound. As we have noted repeatedly, stocks typically move 6 to 12 months ahead of the economy, so waiting for evidence is a doomed strategy. This forward looking nature accounts for the seeming contradiction and confusion that mark the beginning of new cycle of growth.

Indeed, many investors and prognosticators were caught off guard by the dramatic rise in the market, as you could guess from the record mountain of money parked in cash on the sidelines. While there has been some net inflows into equities in the past few months, cash balances are still enormous and most of the investment inflows have gone to the relative safety of bond funds.

S&P 500 Index: Top 20 Quarters

Rank	Quarter Ended	Price Return
1	June 1933	86.50%
2	September 1932	82.39%
3	June 1938	36.00%
4	March 1975	21.59%
5	June 1935	21.18%
6	December 1998	20.87%
7	March 1987	20.45%
8	March 1943	18.53%
9	September 1939	17.77%
10	March 1930	17.20%
11	June 1997	16.91%
12	December 1982	16.79%
13	December 1985	16.04%
14	December 1935	15.88%
15	September 1970	15.80%
16	June 2009	15.22%
17	December 1928	15.18%
18	June 2003	14.89%
19	December 1999	14.54%
20	June 1975	14.19%

Source: Standard & Poor’s, Merrill Lynch Quantitative Strategy and Federated Clover Quantitative Research

Cyclical Bull?

We have refrained from market timing throughout our history and we won't start now. It is clear that the world is in the midst of a serious economic decline and we face many problems. While it is possible that the market could retreat from the recent highs, our point is that prior serious stock market declines have ended with circumstances that look very similar to the past few months. Stocks bottom when the problems seem unsolvable, when fear for the future is palpable, when the majority of investors give up and move to cash. This certainly describes the circumstances of the dark winter of 2008-2009. The next bull market always starts way before there is any sign of recovery.

Where stocks go from here will depend on the economic environment in 2010 and beyond. If global economies stabilize and begin to improve, the March 2009 bottom and the recent rally will be classic in most respects. Given the seriousness of the current problems, we should expect a slow, bumpy journey toward a sound economy. Even so, in our judgment, many stocks represent good opportunity. Further, as Ned Davis Research Inc. notes in their July 2009 Stock Market Focus, "...after previous quarterly gains of at least 15%, the S&P 500 has gained over the next six months in 11 of 15 cases since 1929 and in all eight cases since 1942." Strong gains typically mark the start of a cyclical bull market.

The destructive forces of the economic decline have brought great change to the competitive landscape and productive capacity of many industries. Diverse industries such as investment banking, insurance, automotive supply and several others have seen bankruptcies and restructurings that reduce capacity and may result in better profitability for the survivors when demand rebounds. Our research efforts are focused on finding companies that have survived the downturn and will thrive in the aftermath.

Warren Buffett: "You pay a high price in the stock market for a cheery consensus...Those now awaiting a better time for equity investing are highly likely to maintain that posture until well into the next bull market."

-Forbes Magazine, 8/6/1979

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