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U.S. MARKET COMMENT: BEAR MARKET RALLIES

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Bear Market Rallies

Rallies during this three-year bear market have been little more than head fakes, with short-lived 20% advances followed by rapid retreats. However, since precedent suggests the probability of longer and stronger rallies before the bear market runs its full course, we have taken a look at past rallies to gauge what one might reasonably expect. Most such studies are cluttered with the details of rallies of all sizes and length, thereby muddying the overall picture of the market's primary trend, and so we have focused instead only on the most explosive rallies in past secular bear markets. We established several criteria for inclusion: the index had to drop at least 25%, then subsequently rally at least 40% over the next 12 months. There were seven cases that satisfied these requirements: the S&P 500 during 1929-33, 1937-38, and 1973-74; the FTSE All-Share, 1973-74 and 1976-77; and the Nikkei 225 Average, 1989-93 and 1996-99.

Peaks and Troughs and In-Between

For the S&P 500, the decade following the 1929 crash contained two periods that met our criteria (see Table A). The index fell 86.0% over the 34 months from August 1929 to June 1932, after which it surged 146.3% over the next 12 months. (Note: The size of this rise, as with all rallies, needs to be interpreted with care, for it implies that the market recovered its December 1930 peak and more, which was not in fact the case, as indicated in the table by the number of index points lost and gained during the period under study.) The next sizeable rally occurred during the nine months from April to December 1938 when the market jumped 55.4%. This occurred following a 13-month decline that saw the S&P 500 lose 53.0% of its value. The S&P 500's next major bear market ran from January 1973 to September 1974, during which it dropped 46.2% (see Table B). After bottoming, it promptly surged 49.8% over the next nine months.

The FTSE All-Share suffered two periods of severe decline (see Table C). The first occurred during the 31 months from April 1972 to November 1974 when it dropped 73.8%. After this bottom, the index climbed 116.6% over the next six months. Subsequently, the market fell 45.7% over the nine months from February 1976 to October 1976, which set up a rally of 112.6% over the next 12 months.

The Nikkei 225 peaked in December 1989 before falling 53.8% over the next 31 months (see Table D). The Nikkei then advanced 53.5% over the following ten months. Its next severe descent occurred during the 29 months from May 1996 to September 1998 when it fell 53.2%, before rallying 67.9% over the next 12 months.

The Current Bear Market Through This Historical Lens

Rallies in the current bear market have not even remotely approached the explosiveness of those in past bear markets (see Table E). Since peaking on March 24, 2000, the S&P 500 has rallied three times, for an average gain and duration of 20.3% over 36.3 trading days. This compares with an average 86.0% increase over ten months for the seven periods in this study. Since 2000, the first rally lasted 34 days when the S&P 500 rose 18.9% from April through May 2001; the second lasted 53 days from September to December 2001, rising 21.2%; while the most recent rally lasted 22 days, from July 2002 to August 2002, increasing 20.7%.

On average, the rallies that satisfied our criteria in this study occurred 23 months into the bear market. In comparison, the current bear market has lasted 35 months without a rally of this magnitude. The current wait is not unprecedented, however, as there were two rallies that broke out 31 months after the onset of the bear market (FTSE All-Share, May 1972 through November 1974, and the Nikkei, January 1990 to July 1992).

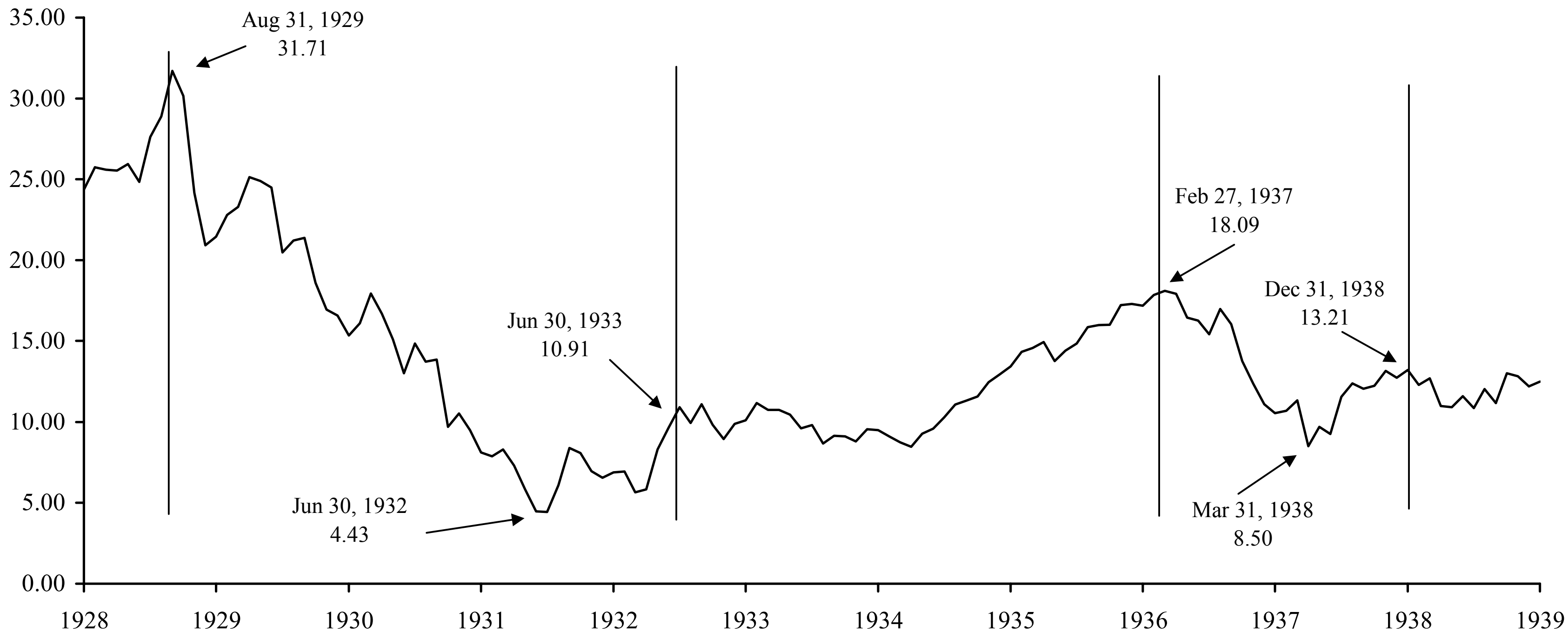
Prelude to a … What?

So what? First, we have no idea whether the market will rally soon or not, and if it does so, for how long and by how much—history teaches us the limitations of simplistic extrapolations of past events. However, investors sitting in cash are certainly in danger of being blindsided and for this reason we recommend against underweighting equities at this time. Second, when equities do rally, they could do so explosively, and we would then recommend that investors rebalance rather than assume the rally must constitute the start of a prolonged recovery. Third, continue to watch the bond and currency markets for clues to the outlook for equities: if the yield curve flattens as a result of long rates declining (rather than short rates rising) and credit spreads widen again while the dollar's decline accelerates—batten down the hatches.

Table A

S&P 500 BEAR MARKET RALLIES

December 31, 1928 - December 31, 1939



Aug '29 - Jun '33	Percent Change (%)	Index Points	Length
Price Decline			
through Jun '32:	-86.0	-27.3	34 mos
Subsequent Rise			
through Jun '33:	146.3	6.5	12 mos

Feb '37 - Dec '38	Percent Change (%)	Index Points	Length
Price Decline			
through Mar '38:	-53.0	-9.6	13 mos
Subsequent Rise			
through Dec '38:	55.4	4.7	9 mos

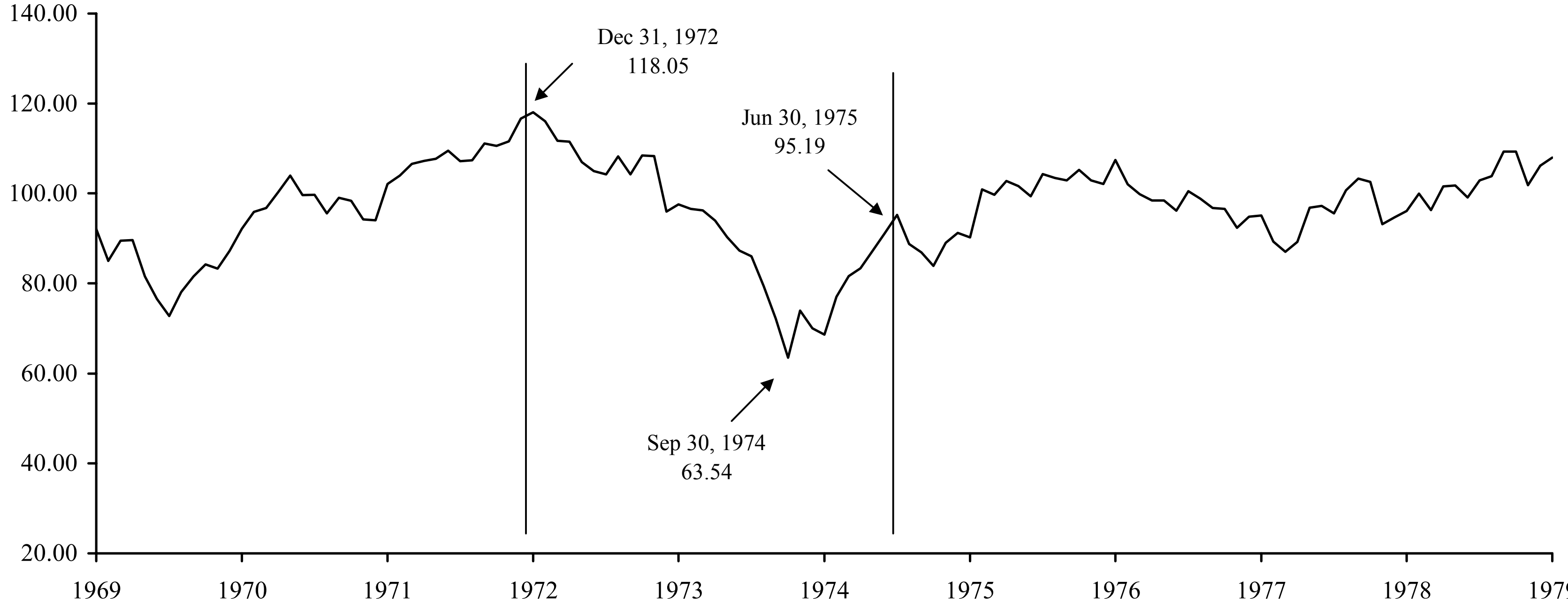
Source: Global Financial Data.

Note: The subsequent rise represents the increase from the trough through its subsequent 12-month peak.

Table B

S&P 500 BEAR MARKET RALLIES

December 31, 1969 - December 31, 1979



Dec '72 - Jun '75	Percent Change (%)	Index Points	Length
Price Decline through Sep '74:	-46.2	-54.5	21 mos
Subsequent Rise through Jun '75:	49.8	31.6	9 mos

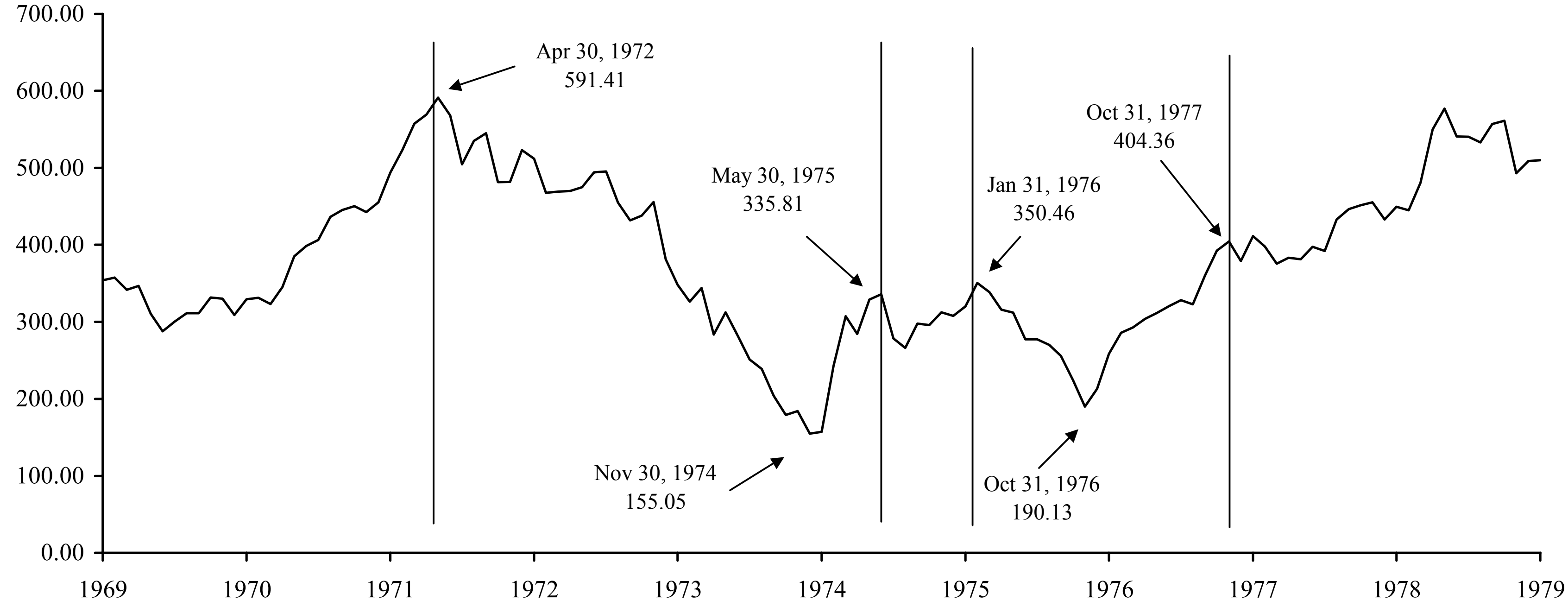
Source: *The Wall Street Journal* .

Note: The subsequent rise represents the increase from the trough through its subsequent 12-month peak.

Table C

FTSE ALL-SHARE BEAR MARKET RALLIES

December 31, 1969 - December 31, 1979



Apr '72 - May '75	Percent Change (%)	Index Points	Length
Price Decline			
through Nov '74:	-73.8	-436.4	31 mos
Subsequent Rise			
through May '75:	116.6	180.8	6 mos

Jan '76 - Oct '77	Percent Change (%)	Index Points	Length
Price Decline			
through Oct '76:	-45.7	-160.3	9 mos
Subsequent Rise			
through Oct '77:	112.6	214.2	12 mos

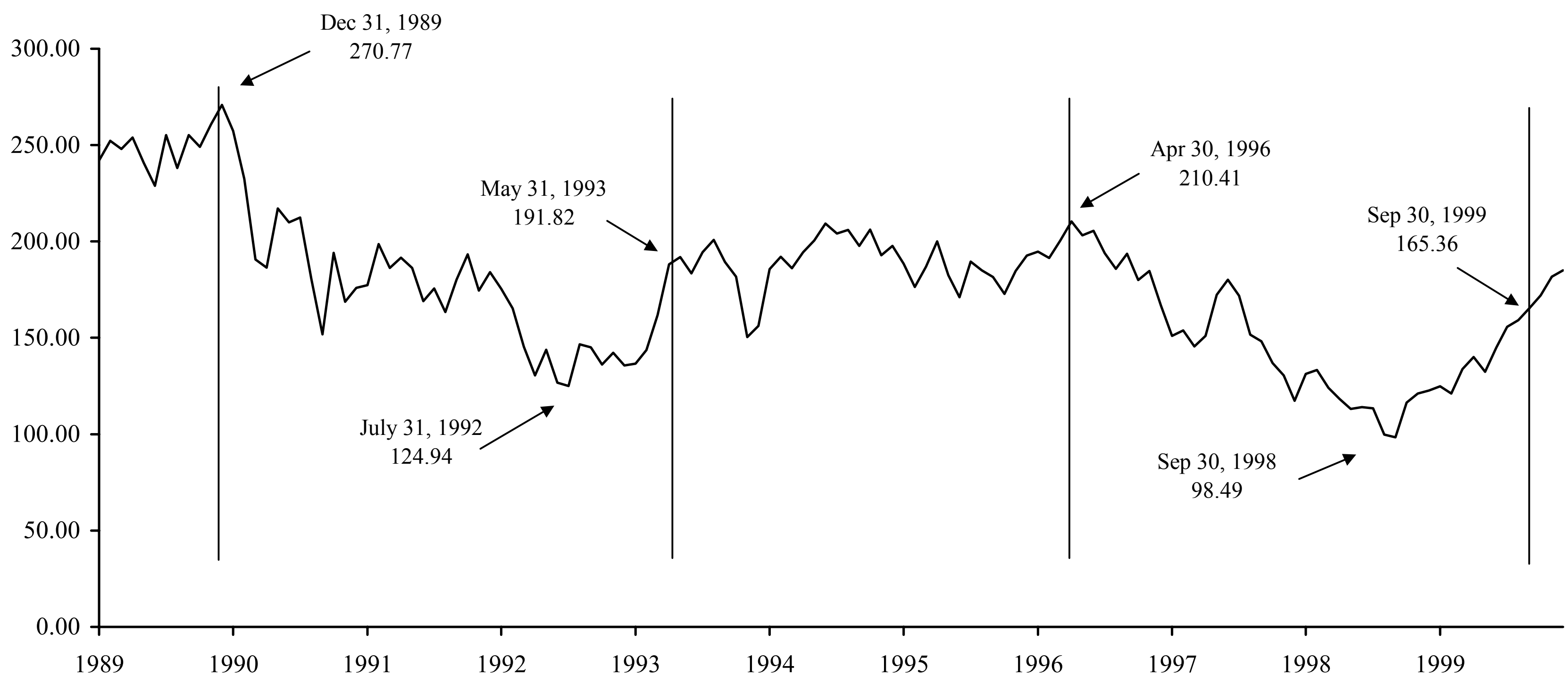
Source: Thomson Datastream.

Note: The subsequent rise represents the increase from the trough through its subsequent 12-month peak.

Table D

NIKKEI 225 BEAR MARKET RALLIES

January 31, 1989 - December 31, 1999



Dec '89 - May '93	Percent Change (%)	Index Points	Length
Price Decline			
through July '92:	-53.8	-145.8	31 mos
Subsequent Rise			
through May '93:	53.5	66.9	10 mos

Apr '96 - Sep '99	Percent Change (%)	Index Points	Length
Price Decline			
through Sep '98:	-53.2	-111.9	29 mos
Subsequent Rise			
through Sep '99:	67.9	66.9	12 mos

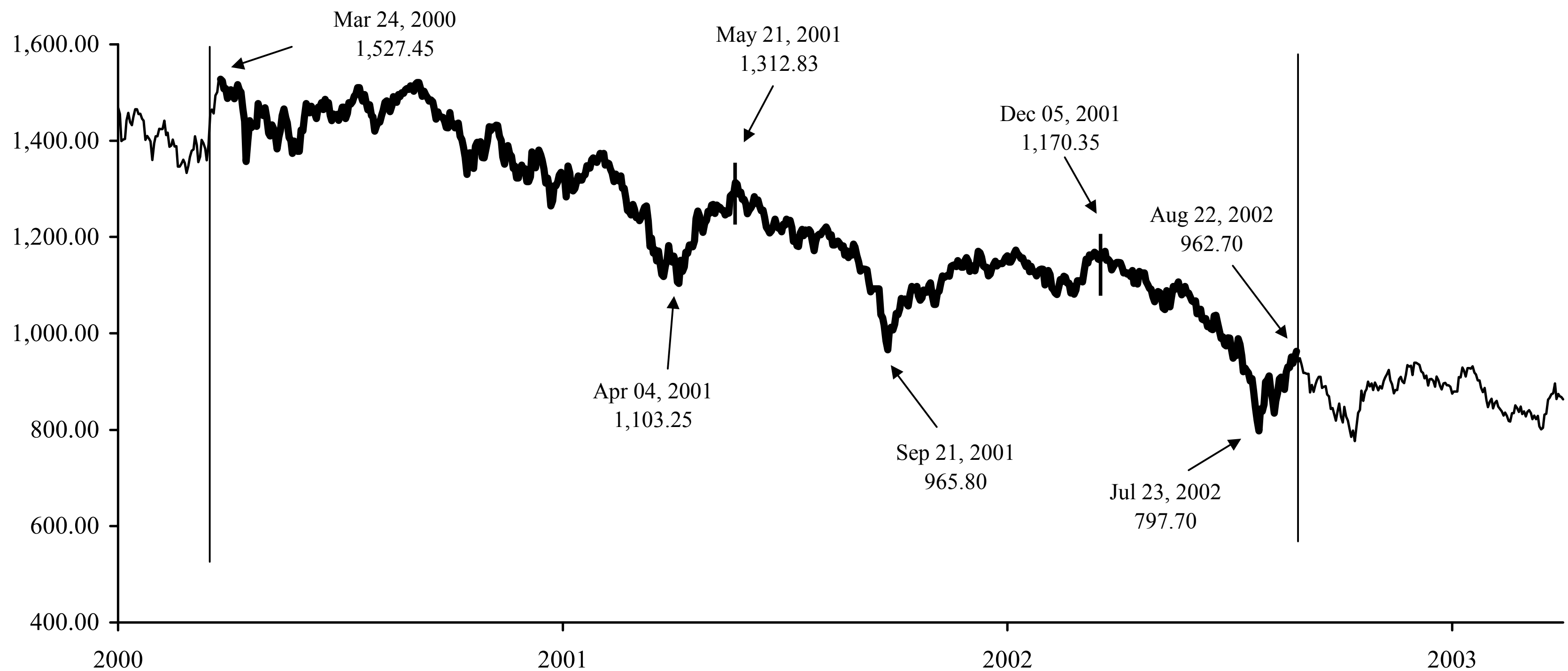
Source: Thomson Datastream.

Note: The subsequent rise represents the increase from the trough through its subsequent 12-month peak.

Table E

S&P 500 BEAR MARKET RALLIES

January 1, 2000 - March 28, 2003



Mar '00 - May '01	Percent Change (%)	Index Points	Length
Price Decline			
through Apr '01:	-27.8	-424.2	269 days
Subsequent Rise			
through May '01:	18.9	209.6	34 days

May '01 - Dec '01	Percent Change (%)	Index Points	Length
Price Decline			
through Sep '01:	-26.4	-347.0	89 days
Subsequent Rise			
through Dec '01:	21.2	204.5	53 days

Dec '01 - Aug '02	Percent Change (%)	Index Points	Length
Price Decline			
through Jul '02:	-31.8	-372.6	164 days
Subsequent Rise			
through Aug '02:	20.7	165.0	22 days

Source: Thomson Datastream.

Notes: The subsequent rise represents a rally of 5% + from the preceding bottom. This graph represents trading days only.