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EUROPEAN MARKET COMMENT: MORE PAIN PENDING? HISTORICAL EVIDENCE IS MIXED

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More Pain Pending? Historical Evidence is Mixed

Compared to the bruising of past bear markets, the current bear market has been more brutal than the downturns in 1976 and 1987, but it generally pales by comparison to the notorious 1972-74 bear. From its peak on September 4, 2000 to September 24, 2002, the FTSE All-Share fell 45.4%, exceeding the 32.6% fall in 1976 and the 36.6% drop in 1987, but far short of the 72.9% plunge in 1972-74. The duration of this bear market is also second only to the 1972-74 decline, which lasted 31.4 months, compared to the 24.6 month descent through September 24. The other two major bear markets in the All-Share's history were relatively short, lasting less than a year (see Table A).

However, the current bear market surpassed the 1972-74 bear market in one respect—the rapidity in which it has surrendered its prior gains. In just over two years, the All-Share has retraced 145.6% of the gains racked up during its previous October 1998-September 2000 rally, compared to 1972-74, when the All-Share took almost seven months longer to retrace a similar percentage (146.0%) of the gains it posted during its May 1970-May 1972 rally. While the current bear market's retracement of prior gains was similar for both bear markets, the 1972-74 bear market erased more years of gains, as the index level dropped below the point where it began in 1962, compared to the current bear market experience of returning to its December 1995 levels. In other words, the 1972-74 bear market gave back more than ten years of gains over 31 months, while the current bear market has retraced five years of gains over nearly 25 months. (Alternatively, if the peak is dated December 31, 1999, it retraced four years of gains over 33 months.) In contrast, the 1976 and 1987 downturns resulted in a smaller retracement of prior gains.

It took years for two of the three past bear markets to break decisively through their prior peaks, which suggests that, even if September 24, 2002 marked the bottom of this bear market, it could be a fairly long slog back to its 2000 peak. After its 1974 trough, it took the All-Share nearly four years (44 months) to exceed its 1972 peak, despite several substantial rallies during the intervening period (118% and 95.2%). In addition, after the market's 1987 trough, it was not until 1991 (45 months) that the All-Share broke through that level, despite rallying 56.2% during the interim. (Note, however, that the index reached, but did break through decisively, their prior peak levels in 1977 and 1989, respectively.) In 1976 the index recaptured its peak in less than six months following its trough. (See Table B.)

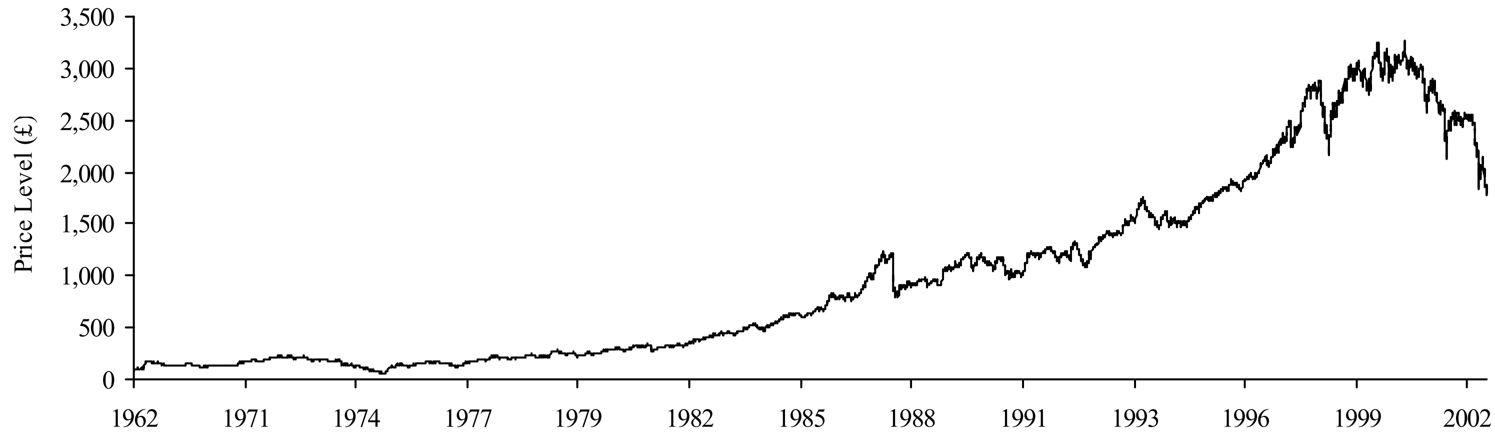
To recapture its 2000 peak within a relatively short period, the All-Share will have to grow at rates that may be far different than what investors are currently assuming (see Table C). Starting from the September 24, 2002 trough, for the index to return to its September 2000 peak by September 2003, it would have to rise 83.2% over the next 12 months; by September 2004, 35.4% each year; and by September 2012, 6.2% per year. By historical comparison, during the four years from the 1974 trough to 1978, the All-Share posted annual returns of 42.9% and 23.4% in nominal and real terms, while during the four years from the 1987 trough to 1991, it posted annual nominal and real returns of 13.0% and 5.4%. From September 24, 2002, if it takes the index four years to recover its 2000 peak, it must rise 16.3% per year until September 2006.

If history is any guide, and equity prices unwind in a pattern similar to the 1976 or 1987 bear markets, then most of the damage has already been inflicted. However, if the current downturn plays out similarly to 1972-74, there still could be more pain to come. One important factor that suggests more downside risk remains is that valuations during all three prior bear markets sunk to much lower levels at market troughs than was reached at the present market bottom. Regardless of whether or not a bottom has been reached, if the past indicates anything about the future, investors should expect substantial volatility over the coming years, as bear markets are typically interrupted by abrupt and powerful rallies. From 1972-74, after falling nearly 73%, the All-Share proceeded to rally 118% in less than three months in 1974-75. In addition, the four years it took from the troughs of the 1972-74 and 1987 bear markets to recapture their prior peaks suggest that investors, instead of trying to identify the bottom, would best be served by preparing for some wild rides for at least the next several years.

Table A

PAST AND PRESENT MAJOR U.K. BEAR MARKETS

FTSE All-Share Index
January 1, 1962 - September 30, 2002



Date of Peak	Date of Trough	Peak to Trough Decline: Nominal	Peak to Trough Decline: Real	Number of Months	Retracement Ratio
5/1/72	12/13/74	-72.86	-80.32	31.41	145.95
1/30/76	10/27/76	-32.64	-39.06	8.90	111.84
7/16/87	11/10/87	-36.64	-37.62	3.84	46.65
9/4/00	9/24/02	-45.42	-47.23	24.64	145.55

Source: Thomson Datastream.

Notes: Bear market is defined as a continuous period with a price decrease of 30% or more. Retracement ratio is the U.K. sterling amount lost, peak to trough, divided by the amount previously gained, trough to peak. It represents the percentage of the prior market rise eliminated by the subsequent period decline. Return data are calculated by using daily price returns expressed in sterling (£). The index return line calculates monthly data between 1962 and 1971 and uses daily data thereafter.

Table B

RETRACEMENT RATIOS OF THE FTSE ALL-SHARE FOLLOWING BULL MARKET PEAKS

Date of Trough	Date of Peak	Trough to Peak Percent rise	Number of Months	Date of Subsequent Trough	Peak to Subsequent Trough Percent Decline	Number of Months	Retracement Ratio (%)
7/29/69	1/14/70	18.10	5.55	5/27/70	-25.33	4.37	165.29
5/27/70	5/1/72	99.68	23.16	12/13/74	-72.86	31.41	145.95
12/13/74	3/7/75	118.01	2.76	3/24/75	-16.01	0.56	29.58
3/24/75	6/6/75	35.91	2.43	8/8/75	-20.66	2.07	78.19
8/8/75	1/30/76	41.21	5.75	10/27/76	-32.64	8.90	111.84
10/27/76	10/21/77	95.19	11.79	3/2/78	-15.79	4.34	32.38
3/2/78	5/7/79	48.48	14.16	11/15/79	-22.54	6.31	69.03
11/15/79	8/17/81	54.03	21.06	9/28/81	-21.49	1.38	61.26
9/28/81	7/16/87	365.89	69.55	11/10/87	-36.64	3.84	46.65
11/10/87	9/8/89	56.19	21.94	9/24/90	-21.51	12.52	59.79
9/24/90	5/11/92	37.86	19.55	8/25/92	-18.11	3.48	65.94
8/25/92	2/2/94	62.42	17.28	6/24/94	-18.04	4.66	46.94
6/24/94	7/20/98	99.55	48.85	10/5/98	-24.92	2.53	49.95
10/5/98	9/4/00	50.78	23.00	9/21/01	-34.84	12.55	111.65
9/21/01	12/6/01	21.98	2.50	7/24/02	-28.87	7.56	160.22
7/24/02	8/27/02	16.26	1.12	9/24/02	-16.96	0.92	121.27
Average		76.35	18.15		-26.70	6.71	84.75

Source: Thomson Datastream.

Notes: Bull market is defined as a continuous period without a price decline of 15% or more. Retracement ratio is the U.K. sterling amount lost, peak to trough, divided by the amount previously gained, trough to peak. It represents the percentage of the prior market rise eliminated by the subsequent period decline. Return data are calculated by using daily price returns expressed in sterling (£).

Table C

PROSPECTIVE ANNUAL RETURNS NEEDED TO RETURN TO PRIOR PEAK

September 24, 2002 Price Level	1,782.6
Peak Price Level	3,266.0
Date of Peak	September 4, 2000

Years to Peak	**Return Needed**
1 Year	83.2
2 Years	35.4
4 Years	16.3
5 Years	12.9
10 Years	6.2
15 Years	4.1
20 Years	3.1
25 Years	2.5

Source: Thomson Datastream..

Notes: Data for 2002 are as of September 30. Returns are based on price levels and are in sterling (£).