

The Bottoming Process

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Editor's note: This is an advance copy of Liz Ann Sonders' newsletter article from the August 21, 2008, issue of *Schwab Investing Insights*®, a monthly publication for Schwab clients.

When I wrote my [New Paradigm Ahead?](#) cover story in May, I knew it would be a theme I'd come back to. What I didn't anticipate was that just three months later, so much of my thesis would already be unfolding, setting the stage for an eventual turnaround in U.S. equities. Recall my original checklist—and the elements of the story that were already in place:

- U.S. economy slows dramatically.
- U.S. Fed cuts interest rates dramatically.
- Dollar sinks further.
- Commodity prices go parabolic.
- Speculative hoarding of commodities ensues.
- Regulators and Congress rev up the anti-speculation rhetoric.
- Commodity-hungry emerging economies suffer.
- Global growth suffers, including noticeably in China.
- Investors shift funds from international stocks to commodities.

Now let's review the original unchecked boxes—and what's changed:

- Non-U.S. central banks consider rate cuts to fight growth slowdown.
- U.S. Fed enters pause mode.

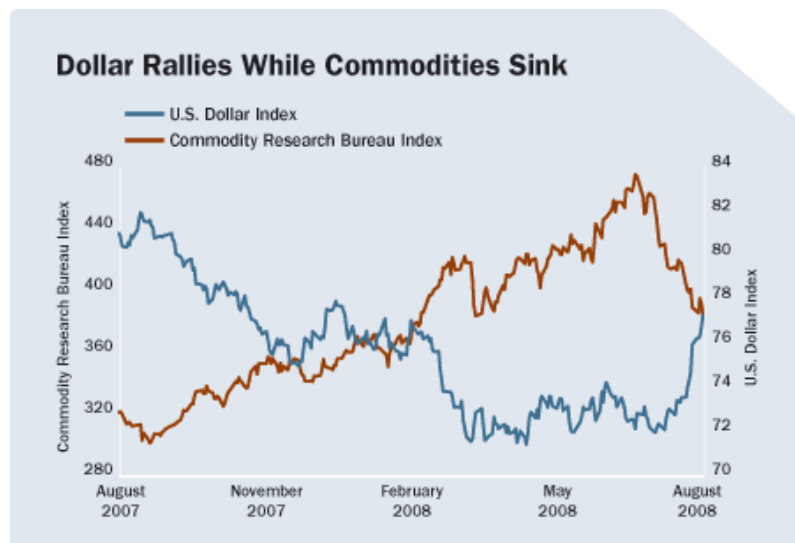
With fewer dissenters than expected, the U.S. Federal Reserve opted to keep rates unchanged in August, while maintaining inflation was a lagging indicator and should ease due to the weak economic environment. Although non-U.S. central banks may not be considering rate cuts yet, many have paused their rate-hike campaigns and openly acknowledged weakening economic growth. In August, the European Central Bank (ECB) left interest rates on hold, stating that risks to Eurozone growth were starting to materialize. The Bank of England (BoE) also decided to keep its key repo rate steady, marking the fifth consecutive month with no change in rates.

The Japanese government recently downgraded its view of the country's economy to "deteriorating," conceding that Japan's longest postwar expansion might be over. And, as we expected, the bloom is even coming off China's rose due to its export dependency. We expect China's growth to slow from a blistering 12.7% pace in mid-2007 to 8% or so by mid-2009—admittedly nothing to sneeze at, but a sign that the U.S. and world economies are hardly "decoupled," as many have argued. The risk of a full-blown global recession is elevated, with UBS economists recently declaring "the world economy is 'precariously close' to a recession in 2009."

- Rate differentials support dollar rally.
- Commodity prices begin to correct.

The "Dollar Rallies While Commodities Sink" chart below is one to behold. Thanks to the recent surge in the U.S. dollar and legitimate concerns about demand destruction, commodity prices are in the midst of a meaningful correction. Through August 8, the Commodity Research Bureau (CRB) Index had its biggest four-week drop in more than 50 years! Oil has been the star of the show with the price down to \$113 a barrel just over a month after scaling \$146. Although an even bigger drop is needed for a major impact on the global economy, oil price relief will go a long way to ease pressure on profit margins and to lower inflation expectations. And it's not just oil! The only two commodities that have held up in the index are live cattle and hogs.

The stronger dollar has also helped alleviate the fear that foreigners would abandon purchases of U.S. Treasuries, causing a spike in long-term rates. With the upside breakout in the dollar, foreign buying of U.S. bonds is likely to accelerate, and we might be re-entering an environment (eventually) in which stocks and bonds can rally together. Plus, with gold and other commodities tumbling, there's even more incentive for foreigners to buy U.S. bonds.



Source: FactSet, as of August 15, 2008.

As we expected, the stock markets of the big oil-exporting emerging economies (viewed as a play on the commodity boom) are also weakening. Russia's and

Brazil's markets peaked in May, along with global energy stocks. From May's highs through August 15, Russia's Russian Trading System (RTS) Index is down 28% and Brazil's Bovespa Index is down 26%.

So where's the dollar headed? Our currency remains cheap on a purchasing parity basis, especially against the euro, and now that the U.S. trade balance is improving rapidly, the dollar's rally could have legs. Dollar rallies (and declines) historically tend to be fairly long-lasting. According to Bespoke Investment Group (B.I.G.), the average rally of 10% or more has lasted 489 calendar days, for a total median gain of nearly 24%. Stocks have liked dollar rallies, with the S&P 500® rising a median 13% during the 11 major dollar rallies since 1967.

- Commodities move from U.S. economic headwind to tailwind.
- Lower commodities/inflation supports U.S. valuation expansion.

It's still too early to put checkmarks on these two boxes. Yes, lower commodity prices have led to a slight uptick in consumer sentiment, but the credit/housing crisis remains a major headwind. As I noted in [Slow Ride: Market Still Digesting More Economic Pain](#), inflation is set to roll over regardless of the price of oil, simply due to easier year-over-year comparisons and its lagging nature. But still-weakening earnings growth remains an impediment to near-term valuation expansion.

Easing inflation is a precursor to a more sanguine view about the U.S. economic outlook. For now, though, I continue to believe we've been in a recession since late last year. Partly confirming my view, fourth-quarter-2007 gross domestic product (GDP) was recently revised downward from +0.6% to -0.2%.

- Investors shift from international stocks/commodities to U.S. stocks.

Finally, although a major shift in investment dollars is not upon us, relative performance among the global stock market indexes may trigger that move sooner than many anticipate. As you can see below, our equity indexes have fared decidedly better than most since the beginning of the third quarter, when commodity prices peaked, the dollar hit a bottom and global growth slowed markedly.

U.S. Equities Now Outperforming International

Index	Quarter to Date	Year to Date
Dow Jones Industrial Average	3.17%	-10.63%
S&P 500 Index	1.72%	-10.40%
Nasdaq Index	7.06%	-7.05%
MSCI Emerging Markets Index	-8.99%	-19.76%
MSCI Euro Index	0.14%	-20.58%
Nikkei Index (Japan)	-3.42%	-14.17%

Source: Bloomberg, as of August 15, 2008.

U.S. stock market's bottoming process

Now that most global stock markets are officially in bear market territory, the next obvious question is whether we're anywhere close to a bottom. As I speculated in previous reports (including May's "New Paradigm Ahead?"), the U.S. economy (and stock market) was the first to sink—and may be the first to recover. But, as we've always reminded investors, bottoms are a process and are next-to-impossible to predict with perfect clarity.

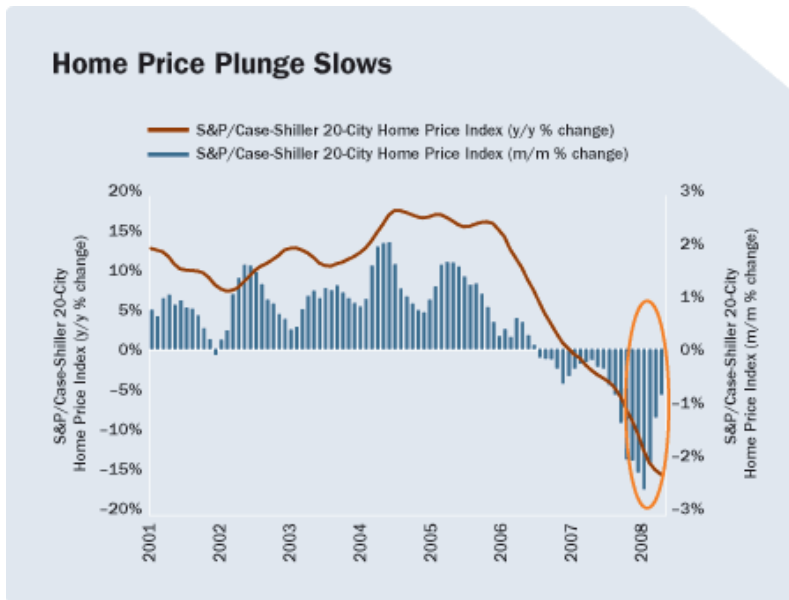
However, there are some brightening factors to consider. The stock market has historically turned before the economy. The average duration of recessions in the postwar period is 10 months, with the stock market generally bottoming about 60% of the way through. So, from a historical perspective, we may be on target, although I think the recession could last longer than the norm this time around, and history is never a perfect guide.

We believe the parabolic up-phase in commodity prices is over, helping headline inflation to retreat soon. That should be a benefit to the market generally, and to equity valuations specifically.

Meanwhile, investors have been shunning domestic equities for several years, and international ones more recently. So, from a strategic asset allocation perspective, we may eventually see some rebalancing in favor of U.S. equities and away from international and commodity-related investments.

Housing's black mark fading

All that said, the credit/housing crisis roars on, with only nascent signs of a bottom. As you can see in the "Home Price Plunge Slows" graph below, month-to-month price declines continue, though at a decidedly slower pace than earlier this year and last. (Watch for my comprehensive report on housing in early September). We believe housing's black mark on U.S. stocks will remain for the time being. That suggests the market's manic-depressive volatility may remain with us until sentiment (or an event) provokes a critical mass of investors to move decisively in one direction or another.



Source: FactSet, as of May 31, 2008.

Are we in the bear market's whimper phase?

The late Sir John Templeton once remarked, "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." I like to think about the opposite for bear markets: They're born on euphoria, grow on denial, mature on panic and die on despair. But they tend to end with a whimper, not a bang. In other words, they have generally hit a "momentum low" (the bang) followed by a period of additional weakness into the "price low" (the whimper), typically lasting about four months. As you can see in the table below, among the 21 major bottoms since 1900, only three have formed coincident with the low in price momentum: 1914, 1957 and 1970. Typically, stocks have slid 4%–5% after the momentum low.

Did the bell ring?

No, I don't necessarily hear the end-of-bear-market bell ringing—they don't actually ring one, by the way. But I will admit it's nice for a change to write about a slightly more optimistic topic!

Bear Markets Usually End With a Whimper, Not a Bang

Bear Markets	Bull Market High to Bear Market Low	Bang: Bull Market High to Momentum Low ¹	Whimper: Momentum Low to Bear Market Low
	Decline (Trading Days)	Decline (Trading Days)	Decline (Trading Days)
6/17/1901–11/9/1903	-46% (594)	-46% (577)	-1% (18)
1/19/1906–11/15/1907	-49% (460)	-26% (289)	-31% (171)
9/30/1912–7/30/1914	-24% (456)	-24% (456)	0% (0)
11/21/1916–12/19/1917	-37% (267)	-18% (21)	-22% (246)
11/3/1919–8/24/1921	-47% (450)	-44% (282)	-4% (168)
9/7/1929–6/1/1932	-86% (676)	-45% (43)	-75% (633)
9/7/1932–2/27/1933	-41% (117)	-31% (23)	-14% (93)
7/17/1933–3/14/1935	-34% (410)	-29% (60)	-6% (350)
3/6/1937–3/31/1938	-55% (267)	-42% (155)	-21% (112)
11/9/1938–4/28/1942	-44% (628)	-31% (143)	-18% (485)
5/29/1946–5/17/1947	-29% (228)	-24% (59)	-6% (168)
7/15/1957–10/22/1957	-21% (70)	-21% (70)	0% (0)
12/12/1961–6/26/1962	-28% (128)	-24% (108)	-6% (20)
2/11/1966–10/7/1966	-22% (167)	-21% (139)	-2% (28)
11/29/1968–5/26/1970	-36% (369)	-36% (369)	0% (0)
1/11/1973–10/3/1974	-48% (436)	-46% (422)	-5% (14)
9/21/1976–3/6/1978	-19% (366)	-16% (276)	-5% (90)
11/28/1980–8/6/1982	-27% (430)	-20% (222)	-9% (208)
8/21/1987–12/4/1987	-34% (71)	-33% (38)	0% (33)
3/24/2000–10/9/2002	-49% (638)	-48% (582)	-3% (56)
Medians			
1900 to date	-36% (410)	-29% (155)	-5% (93)
1945 to date	-28% (297)	-24% (181)	-4% (31)
Current Bear Market			
10/09/07–07/15/08	-22% (193)	-22% (193)	0% (0)

Source: The Leuthold Group.

Important Disclosures

1. Momentum measured by percentage deviation in the S&P 500 (Dow Jones Industrial Average used prior to 1929) from its 50-day moving average. Days adjusted to a five-day trading week prior to May 1952, when the market was open on Saturdays for a half session.

The Dow Jones Industrial Average is a price-weighted average of 30 blue chip stocks that are generally the leaders in their industry.

The S&P 500 index is an index of widely traded stocks.

The Nasdaq Composite Index is a broad-based capitalization-weighted index of stocks in all three Nasdaq tiers: Global Select, Global Market and Capital Market.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

As of May 2005, the MSCI Emerging Markets Index consisted of the following 26 emerging market country indexes: Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

The MSCI Euro Index is a subset of the broader MSCI European Monetary Union (EMU) Index. The MSCI Euro Index comprises large and liquid securities with the goal of capturing 90% of the capitalization of the broader MSCI EMU benchmark, which, as of June 2007, consisted of the following 11 developed market country indexes: Austria, Belgium, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal and Spain.

The Nikkei Index is a price-weighted average of 225 top-rated Japanese companies listed in the First Section of the Tokyo Stock Exchange.

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