PHILO CAPITAL ADVISERS

HAVE SHARE PRICES BOUNCED BACK TOO QUICKLY AND TOO FAR?

- A TALE OF STOCK MARKETS, RECESSIONS, DEPRESSIONS & DEBT

ASHLEY OWEN, **CFA**

JOINT CEO, PHILO CAPITAL ADVISERS PTY LTD

FEBRUARY 2010

PHILO CAPITAL ADVISERS PTY LTD

ABN 70-119-185-974 AFSL 301808

LEVEL 3, 7 MACQUARIE PLACE SYDNEY NSW 2088 AUSTRALIA

Have share prices bounced back too quickly and too far?

- a tale of stock markets, recessions, depressions & debt

The New York Times on Friday 28 July ran the following front page headlines about a violent clash between 1,500 US troops and 20,000 "bonus" rioters outside the White House in the centre of Washington DC:

- *"TROOPS PUT AN END TO BONUS RIOTING IN THE CAPITAL"*
- *"1 KILLED, SCORES HURT IN DAY OF STRIFE"*
- *"BOMBS AND SABRES WIN CAPITAL BATTLE" and*
- *"AT MIDNIGHT 20,000 OF BONUS ARMY IS HELD BY THE MILITARY"*

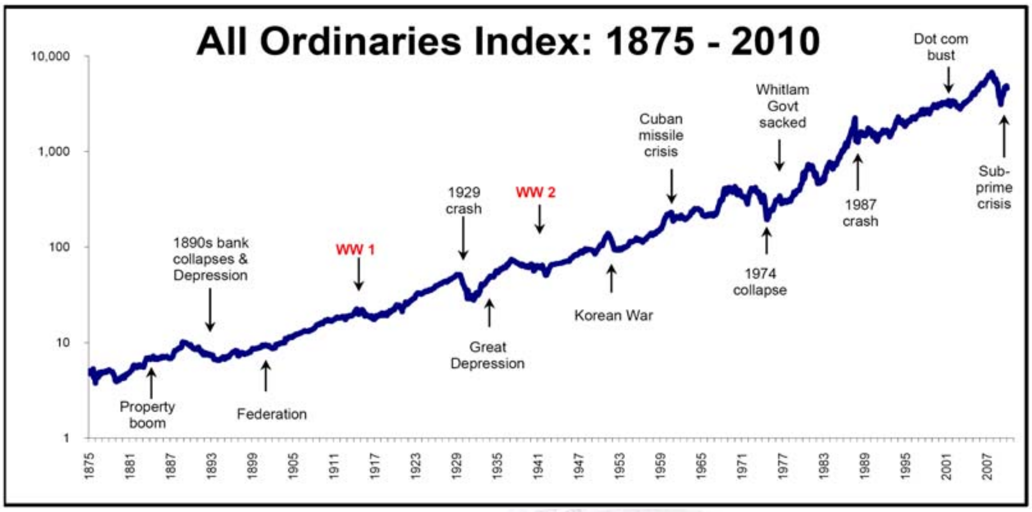
Were US citizens rioting against the Wall Street bankers' obscene bonuses paid for by taxpayer-funded bailout money? The very bankers who caused the sub-prime crisis that led to 7 million Americans losing their jobs and countless millions losing their homes? They certainly had every reason to riot in the streets and march on Washington. But in fact these front page headlines were actually from the New York Times on Friday July 28, ***1932***. The 20,000 "bonus rioters" were World War 1 veterans rioting for veteran bonus payments. It was the middle of the Great Depression and the rioters had set up camp in Pennsylvania Avenue next to the White House and had fought off raids by the local police for a month. Finally President Hoover lost patience and sent in 1,500 troops with tanks and machine guns to drive them out of Washington, fearing a rising communist influence behind the riots. With US troops firing on their own citizens, right in the middle of Washington, one third of American workers were unemployed and industrial production had collapsed by half – this surely was the low point in the Great Depression in America.

But another lead article on same front page of the New York Times on the same day told a very different story. It was headlined: "*STOCKS RISE AGAIN IN YEAR'S HEAVIEST TRADING*", and the story began: "Invigorated by fresh optimism, the security markets made another broad advance today…". It even included extraordinary comments about "…the cheerfulness on Wall Street…". The following article is a story of how stock markets rise out of the very depths of recession and depression - while fear, chaos and uncertainty are at their most extreme.

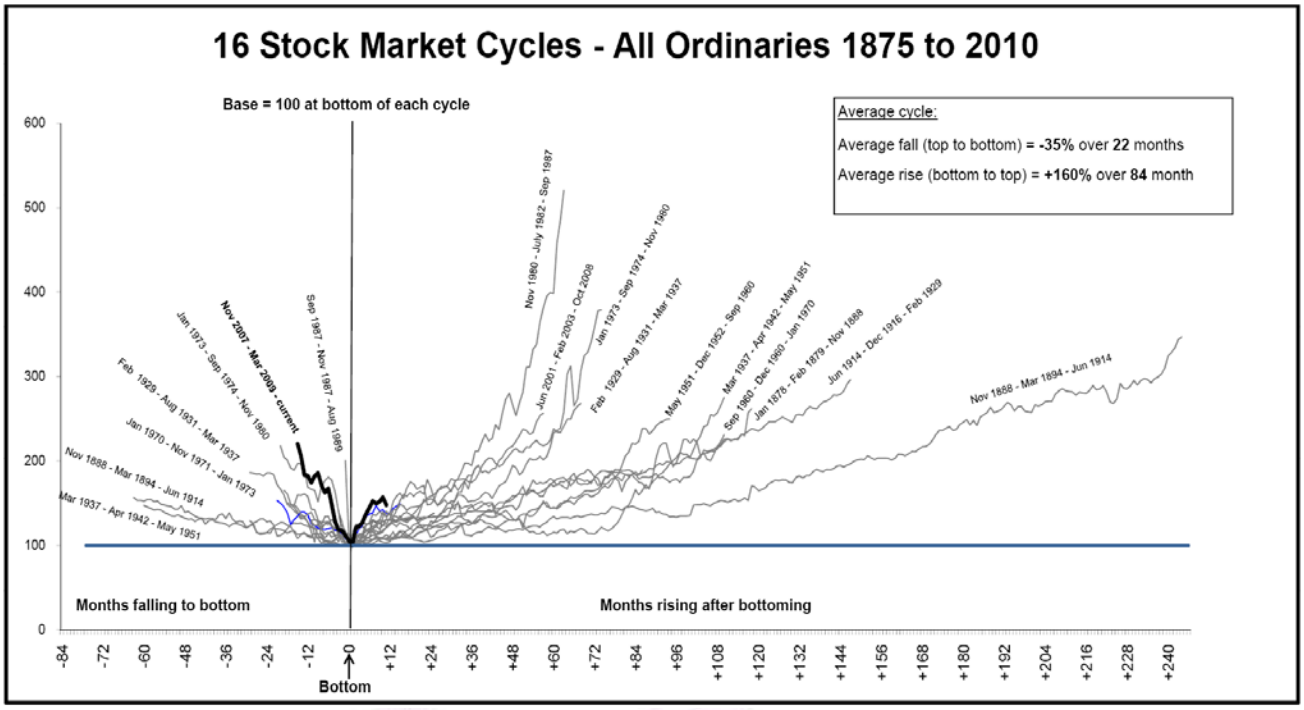
The Sub-prime crisis

The US sub-prime crisis has certainly taken stock markets for a wild ride over the past couple of years as the crisis spread from a US housing crisis, to a US lending crisis, then to a global credit crisis, and then the worst global economic contraction and financial crisis since the Great Depression. The Australian stock market followed a very similar path to all other major markets around the world. The All Ordinaries Index peaked at the start of November 2007 and fell 54% before reaching the bottom in early March 2009. From the depths of despair in March 2009, the Australian market has bounced back strongly to be up 48% by February 2010. Was this bounce back premature? Will it last? Because Australians hadn't seen a recession since the early 1990s, or a major stock market collapse since 1987, we first need to put the recent collapse and bounce-back into perspective.

The Australian stock market has delivered outstanding returns to shareholders over the long term, but the ride has had numerous ups and downs along the way. Chart 1 shows the course of the All Ordinaries Index over the past 130 years. The market has survived through two major global depressions (in the 1890s and 1930s), two World Wars, the rise and fall of fascism and communism, several banking and financial crises, numerous local recessions, droughts, bouts of high inflation and deflation, political shocks, currency collapses and a host of other crises.



There have been 16 major cycles of Australian stock market collapses and recoveries over the whole period. The next chart shows these cycles superimposed on a single time line so that the falls and subsequent rises during each cycle can be compared.

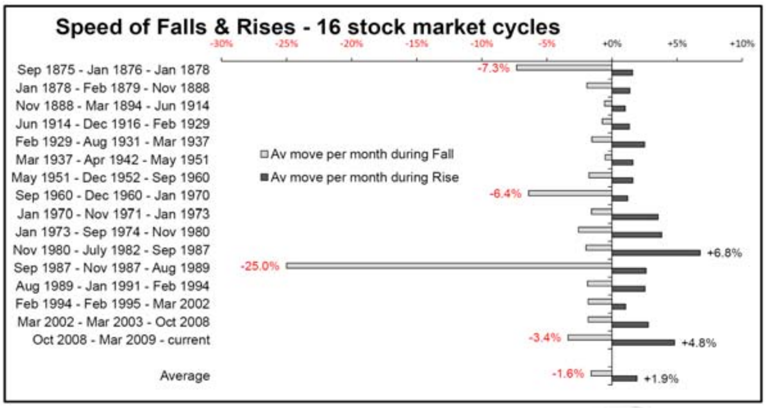


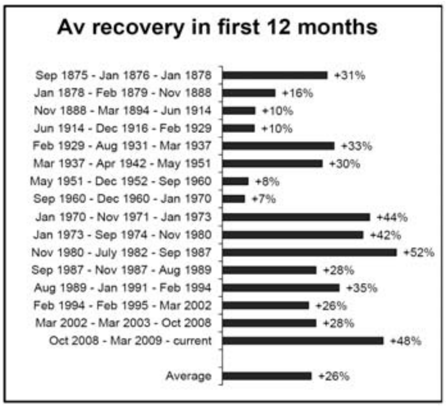
The 2008 collapse

The above chart shows that, although it certainly seemed sudden and catastrophic at the time, the 2008 collapse was similar in scale to the falls in 1929-32, 1973-4, 1980-2 and 1987. The largest overall top-to-bottom fall was -61% between 6th January 1970 and 30th September 1974 (which combines cycles 9 and 10). In terms of the suddenness of the falls, the 1987 collapse was fastest of all. The market index lost a little over 50% in just 37 trading days during September and October 1987, including 25% on a single day – Tuesday 20th October - plus five further days of at least 5% losses each. The recent sub-prime collapse took an agonizing 15 months, and contained 5 days worse than 5% loss and a further 14 days worse than 3% loss, but at least we had no one big crash day like 20th October 1987. The details of each cycle are set out in the table at the end of this article.

The 2009 bounce back – thus far

The bounce back in 2009 was strong – but it was very similar to previous bounces out of the middle of previous recessions and crises. The next charts show that the latest bounce-back was similar in speed and extent to the several previous cycles, and that the first 12 months of the bounce-back has been similar to several previous initial recoveries:





The next chart shows the speed of the first 12 months of the recoveries as a ratio of the speed of the falls preceding them. "Speed" is measured here as the average monthly move in the market index. In the current recovery since March 2009, the All Ordinaries index has risen at the speed of +4.0% per month, compared to the speed of falling -3.4% per month in the collapse between November 2007 and March 2009, so the ratio of speed of recovery to the speed of the fall is 1.2.

The speed of the recovery has been faster than the fall, and this is giving rise to the fear that the recovery has been too fast and has therefore been "over-done". However, we see that in 10 out of the previous 15 cycles, the speed of the first 12 months of recovery was also faster than the speed of the falls (the circled ratios below with a speed ratio of more than 1.0).

Recovery Speed Ratio - Ratio of the Speed of the Rise in the first 12 months of Recovery, to the Speed of the Fall:

CYCLE	1	2	3	4	5	6	7	8	9	10	11	12	13	14	15	16	Averages
Top	Sep 1875	Jan 1878	Nov 1888	Jun 1914	Feb 1929	Mar 1937	May 1951	Sep 1960	Jan 1970	Jan 1973	Nov 1980	Sep 1987	Aug 1989	Feb 1994	Mar 2002	Oct 2008	
Bottom	Jan 1876	Feb 1879	Mar 1894	Dec 1916	Aug 1931	Apr 1942	Dec 1952	Dec 1960	Nov 1971	Sep 1974	July 1982	Nov 1987	Jan 1991	Feb 1995	Mar 2003	Mar 2009	
Top	Jan 1878	Nov 1888	Jun 1914	Feb 1929	Mar 1937	May 1951	Sep 1960	Jan 1970	Jan 1973	Nov 1980	Sep 1987	Aug 1989	Feb 1994	Mar 2002	Oct 2008		
Ratio of speed of Rise in first 12 months to speed of Fall	0.4	0.7	1.4	1.1	1.8	4.7	0.4	0.1	2.3	1.4	2.2	0.1	1.5	1.2	1.3	1.2	1.4

Share prices move much more quickly than people expect – and always well in advance of the underlying fundamentals. Collapses in share prices are always disturbing and quicker than anybody would like, but the recoveries are generally even faster than the falls. The same has been true again in the current cycle. The only exceptions to this general pattern over the past century have been:

- Cycle 7 – the Korean War recession – speed ratio of just 0.4, meaning stocks rose half as fast as they fell
- Cycle 8 – the 1960-1 recession - the speed ratio was only 0.1 because shares only fell for just 3 months (a moderate fall of 20%) and then recovered moderately as well (+0.5% per month)
- Cycle 12 – the 1987 crash, where prices collapsed 50% in just 37 trading days. The speed of the first 12 months of the recovery was +2.3%, which is spot on the overall average recovery speed for all cycles, but the speed ratio was just 0.1 simply because of the sheer cliff-like fall on 20th October 1987.

What is worrying the market?

If both the extent and the speed of the current recovery are in line with previous cycles, including the "big ones" like the two global depressions and the two world wars, what then is worrying the market this time? There are three main factors:

1. Share prices have risen, but economies are still weak, companies are reporting losses and dividends are being cut.
2. Unemployment and bad debts are still high and/or rising in many countries
3. Government debt problems are appearing in several countries, with several facing possible default

The first is a question of timing. Stock markets have generally bounced back strongly out of the *middle* of recessions – even in the middle of the major depressions in the 1890s and 1930s, and in numerous less serious recessions and contractions. Share prices start rising off the bottom even while the underlying economy is still contracting, while unemployment is still climbing, while bad debts are rising, and while dividends are being cut.

Please note, this report is an exerpt of the original report only. A significant number of pages have been removed from this report.

Please complete the form on the Philo Research tab of Philo's web site www.philocapital.com.au if you would like to receive a full copy of this report.

Produced by PHILO CAPITAL ADVISERS