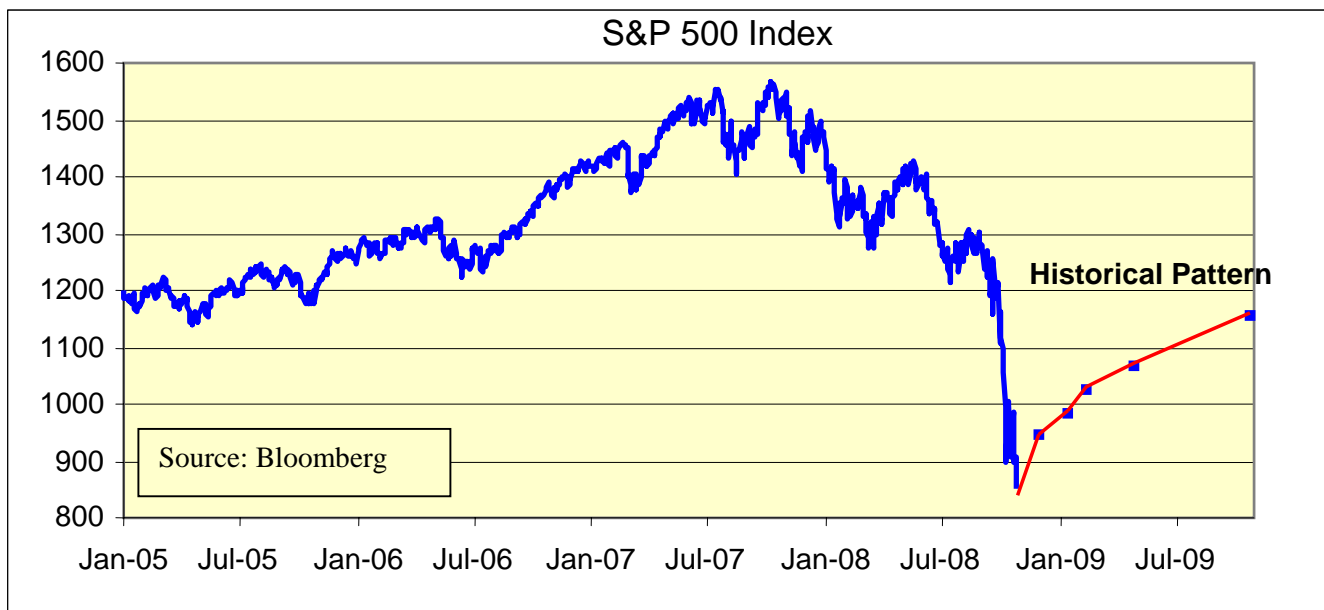


November 2008

## Bouncing markets

Turmoil experienced by the world's equity markets through much of 2008 has moved financial stories from the business section to the front page. As uncertainty over the stability of the world's financial system came to a head, volatility increased to unprecedented levels. Daily trading ranges that had widened to exaggerated levels in the spring and summer moved to extremes during the fall. Not surprisingly, this volatility created uncertainty that led to all-time lows in confidence and investors headed to the sidelines. Domestically, a stock market that had seen an all-time high just before mid-year experienced a reversal that would produce the second-largest percentage decline in the post-Second World War era. Nevertheless, as history has shown, the inevitable rebound from a bear market can occur quickly, leaving only those with the foresight and fortitude to stay invested to take full advantage of subsequent market gains.

### S&P 500 Index



The graph shows changes in the level of the S&P 500 Index from January 2005 through October 27, 2008 (in blue) and indicates how the level could change in the future, assuming it follows the historical pattern. The red line shows how the index would look if a recovery began immediately and it followed the average pattern of the 10 bear market recoveries since the Second World War.

U.S. markets have been the focal point of much of the concern over the financial system meltdown. Problems originating with sub-prime mortgages and asset-backed commercial paper came to the surface as the U.S. housing market weakened. These problems quickly spread to all corners of the globe as elevated levels of leverage in complex derivative products ensured that all markets were affected. A massive, coordinated intervention from the world's governments and central banks has been required to thaw out frozen lending flows. Government loans and guarantees, coupled with cuts to administered interest rates, have slowly helped prompt a return to a more normal flow of funds.

The broader U.S. market (as represented by the S&P 500 Index) closed at an all-time high of 1,565.2 on October 9, 2007. Over the subsequent year, the failures of a number of high-profile financial firms took their toll and the index gave up 45.8% on its way to a close of 848.9 on October 27. Still, investors taking a long-term view have been the buyers of these U.S. equities on the way down. As with prior bear markets, recoveries can come swiftly, thus penalizing market players who moved to cash at the bottom. The table below summarizes the average pattern of change for the S&P 500 Index in the immediate aftermath of the 10 bear market episodes since the Second World War.

<b>S&amp;P 500 Bear Market Recoveries Since the Second World War</b>		
	Days	Actual %
Average Decline	<b>384</b>	<b>-30.5%</b>
Time to regain 10% from bottom	<b>33</b>	<b>11.0%</b>
Time to regain 15% from bottom	<b>81</b>	<b>15.8%</b>
Time to regain 20% from bottom (bull signalled)	<b>110</b>	<b>20.5%</b>
Time to regain 25% from bottom	<b>185</b>	<b>25.6%</b>
Gain after 1 year from bottom	<b>365</b>	<b>36.0%</b>
<b>Current Decline (as of October 27, 2008)</b>		
	<b>384</b>	<b>-45.8%</b>
<b>Projection using historical averages</b>		
	Date	Level
Recent low close	<b>27-Oct-08</b>	<b>848.9</b>
Projected 10% from bottom	<b>29-Nov-08</b>	<b>942.1</b>
Projected 15% from bottom	<b>15-Jan-09</b>	<b>983.2</b>
Projected 20% from bottom (bull signalled)	<b>13-Feb-09</b>	<b>1023.2</b>
Projected 25% from bottom	<b>29-Apr-09</b>	<b>1066.3</b>
Projected 1 year from bottom	<b>27-Oct-09</b>	<b>1155.0</b>

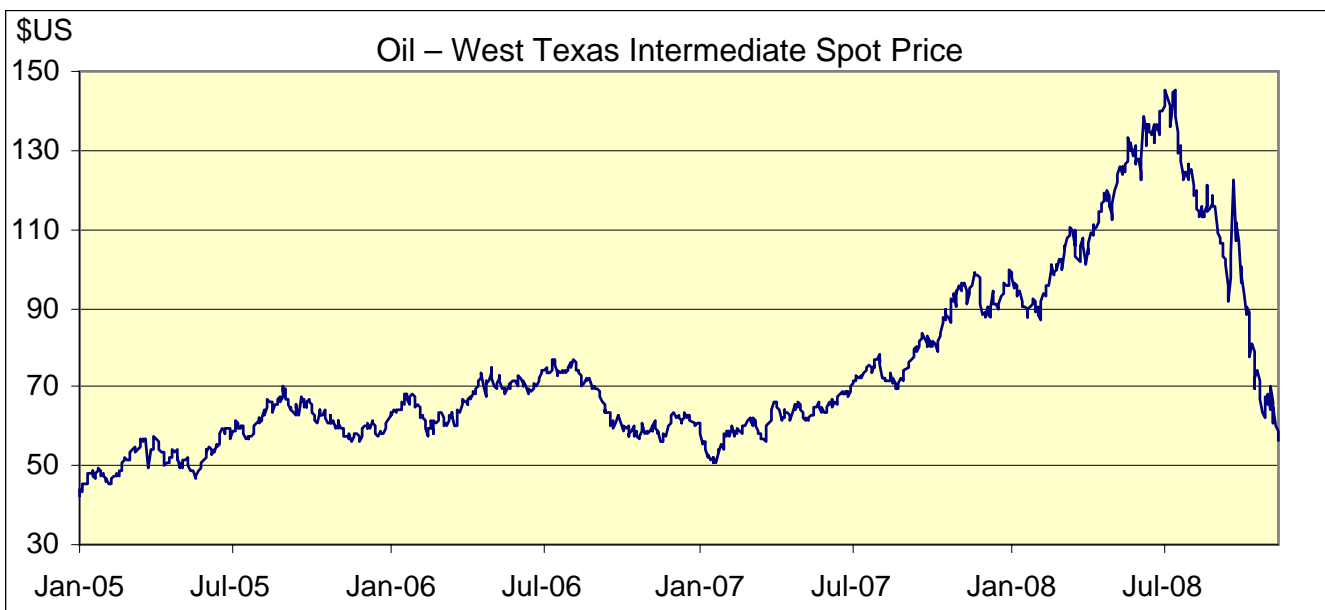
Source: Bloomberg

The current period of decline is now in line with the average of the bear markets since the Second World War in terms of elapsed time and greater than prior average declines in terms of percentage loss. Even though this does not assure us that the market bottom has been reached, it is likely that the present timing makes it closer rather than further away. If so, as can be seen in the “average” recovery pattern above, the emergence of a similar pattern now would place the appearance of a bull market signal from the S&P 500 some time near mid-February 2009. While there are no guarantees that this will take place, history has shown that attempting to time a move back into the market has significantly damaged returns for the average investor. A full recovery and a subsequent move to new highs will eventually come. Just as no one rings the bell at the market bottom, waiting on the sidelines for the “all clear” signal raises the probability that a large portion of the move higher will be missed.

## **TSX**

On the domestic front, the Canadian equity market remained resilient into mid-2008. Given all that has happened since, it is almost challenging to recall that the S&P/TSX Composite Index posted a record high of

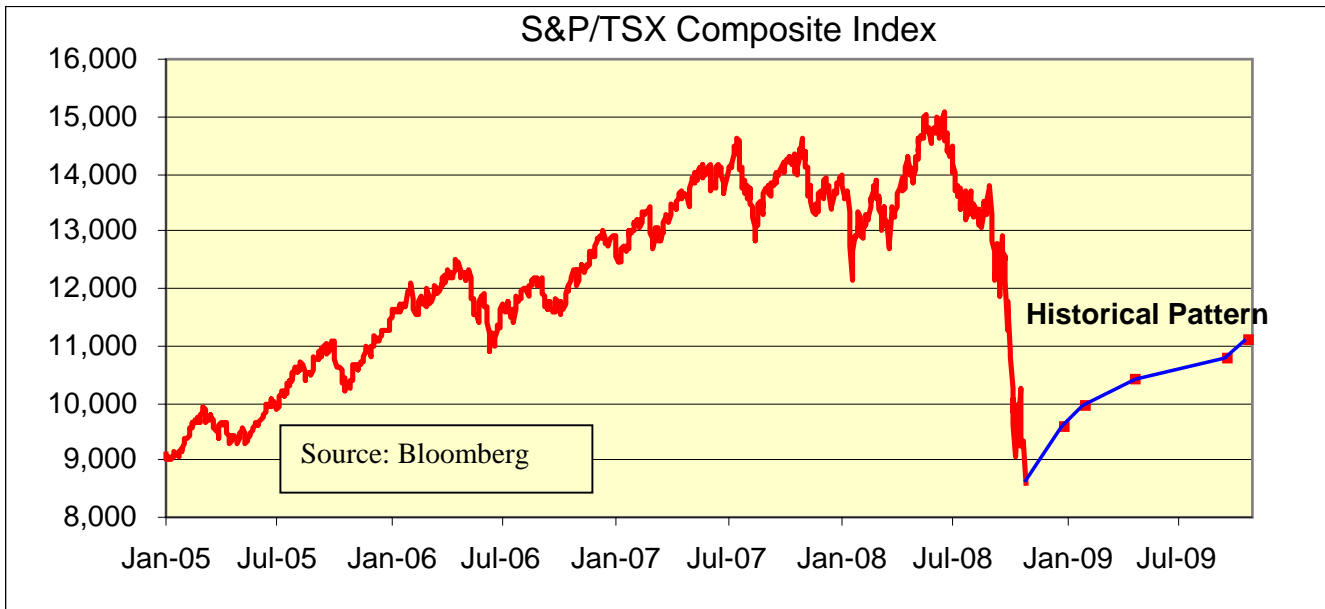
15,073.13 as recently as June 18, 2008. Not surprisingly, the commodity prices that led the index on the way up have done some serious damage on the way back down. After peaking at US\$147.27 per barrel on July 11, 2008, world oil prices have seen a rapid decline. A concerted effort by the Organization of Petroleum Exporting Countries to curtail production quotas for its member nations has, thus far, failed to offset the prevailing negative market tone. Expectations for a protracted slowdown in the global economy have produced a 60% decline in market prices for oil over an astonishingly short four-month period. Preliminary statistics suggests that oil imports into the U.S. hit a new five-year low during August even as the largest monthly price decline on record appeared. It's likely that once the data are released, they will show that the decline continued through to the end of the quarter.



Source: U.S. Energy Information Administration

The rapid drop in energy prices has been clearly reflected in the equity market. Unlike the U.S. market where the move down has taken more than a year, the Canadian market has seen less than five months to record a similar drop. Not surprisingly, this rapid retreat has been accompanied by exaggerated volatility. Trading ranges on the index have moved to historic levels. From the beginning of January 1985 to the end of August 2008, there were only 16 trading days – out of a total of 5,919 trading days (or 0.3% of the time) – where the TSX experienced a 5% or greater trading range<sup>1</sup>. This works out to one every 18 months. However, in September and October 2008, there were 21 trading days where the TSX experienced a trading range of more than 5%. As there were 43 trading days in these two months, this works out to 48.8% of the time.

<sup>1</sup> The “trading range” on a per cent basis is calculated as the difference between the high and the low for the day as a per cent of the previous day’s closing level.



The graph above shows changes in the level of the S&P/TSX Composite Index from January 2005 through October 27, 2008 (in red) and indicates how the level could change in the future, assuming it follows the historical pattern. The blue line shows how the index would look if a recovery began immediately and it followed the average pattern of the 10 bear market recoveries since the Second World War.

<b>TSX Bear Market Recoveries Since the Second World War</b>		
	Days	Actual %
Average Decline	381	-31.7%
Time to regain 10% from bottom	66	12.3%
Time to regain 15% from bottom	97	16.4%
Time to regain 20% from bottom (bull signalled)	182	21.6%
Time to regain 25% from bottom	330	25.9%
Gain after 1 year from bottom	364	29.7%
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Current Decline	131	-43.4%
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Projection using historical averages	Date	Level
Recent low close	27-Oct-08	8537.3
Projected 10% from bottom	01-Jan-09	9584.5
Projected 15% from bottom	31-Jan-09	9936.2
Projected 20% from bottom (bull signalled)	27-Apr-09	10379.9
Projected 25% from bottom	22-Sep-09	10752.6
Projected 1 year from bottom	26-Oct-09	11072.0

Source: Bloomberg

As in the case of the U.S. market, there are no guarantees that the domestic market has reached the bottom of the bear market. However, using the low close on October 27 as a starting point and the above historical averages as a reference, a bull signal for the Canadian market would be forecast to arrive in the spring of 2009.

## **Conclusions**

- Dramatic increases in volatility have fuelled understandably heightened anxiety among investors. Relying on professional advice can help take emotion out of the equation and refocus attention on the long run.
- While the events behind bear markets have changed over time, history has shown that markets do recover and subsequently move on to new highs.
- Exiting the market near the bottom virtually guarantees that those investors will miss out on significant gains when the inevitable rebound occurs.

**Richard J. Wylie CFA**  
**Vice-President, Investment Strategy**  
**Assante Wealth Management**

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