

As many of you are aware, the stock market has not been performing well since early October of 2007. (For those who are really paying attention, most stock markets are actually lower from where they were 10 years ago). Regardless of the reasons, it appears that we have entered a bear market. Unfortunately, such a judgment only becomes clear in retrospect. However, given the warning signs we have seen already, it is important to review the rules and characteristics of bear markets.

A careful examination of what took place in Japan over the last 20 years provides an illustration of a bear market process. On December 31, 1989 the Japanese stock market hit a high valuation of 40,000. As the Japanese stock market was hitting a high so was both commercial and residential real estate. Soon, the Japanese stock market began to deflate, and along with it both commercial and residential real estate property values began to slide. To combat this decline, the Bank of Japan employed several tactics similar to what we seen by the Federal Reserve. For instance, they lowered interest rates dramatically and they began to bail out banks that had made bad real estate loans. Unfortunately, it is the bear market process that won this battle and not the Bank of Japan, as the Japanese stock market today trades at a mere 13,000. This means that the Japanese stock market is still down 67% from where it was almost 20 years ago. Likewise, commercial and residential real estate values in Japan declined an average rate of 8% for 14 consecutive years. You can only imagine how demoralized the Japanese investor is after such a period of declining prices.

A bear market, therefore, can be described as a period of declining asset prices accompanied by widespread pessimism. Investors begin to anticipate further losses and become motivated to sell. This negative sentiment begins to feed on itself in a vicious circle. It is not limited to just the stock market as illustrated with the Japanese example. It can affect all assets including stocks, bonds, real estate, and commodities. Reviewing the characteristics of a bear market is relevant, because we are at a critical juncture both fundamentally and technically. In other words, we could be at the doorstep of a brand-new bull market or simply in a rally within the context of a bear market. Because very few people can navigate a bear market successfully, I find it much more important to understand a bear market process. The government, specifically the Federal Reserve, has embarked on a historic program to alleviate the credit crunch utilizing tools not seen since the 1930s. They have lowered interest rates, negotiated sales of bad banks and brokers, and took bad or questionable assets from banks and replaced them with good assets from their own balance sheet.

We are now at a critical juncture because if economic problems worsen, the Federal Reserve will be viewed as completely ineffective. Increasing the odds of this outcome, James Dimon, J.P. Morgan Chase's & Co.'s chief executive, said Monday, May 19, 2008, "While the crisis in the credit markets appeared to be three quarters over, a US recession is just beginning". It is this psychology which is characteristic of a bear market that should create the most worrying. This type of psychology shows up at the worst possible times. In other words, just as you need the Federal Reserve the most, the prevalent psychology will be that there is nothing more they can do.

If the United States begins to fall into a recession as most experts predict, and the Federal Reserve has already done those things described above, it can be easily justified in investor's mind that there is no hope. It is that sort of vicious circle that is characteristic of a bear market. It's not a prediction as to what is going to happen, but this is a possibility that can be used to demonstrate how bear market psychology can become important in deciding upon any investment. Therefore, from an investment standpoint, given the probability that we are in a bear market it is prudent to remain cautious. This cautiousness should be reflected in investors' portfolios through limited amounts of stocks, high cash balances and conservative bond holdings. In addition to this conservative stance, it is sensible to employ trading strategies that take advantage of the increasingly frequent wild swings in the stock market. A properly employed trading strategy can enhance overall results.

Todd Horlbeck
May 2008

No warranty or guarantee is given regarding the accuracy, reliability, veracity, or completeness of the information provided here. Under no circumstances will the author or service provider be liable for any loss including but not limited to direct, indirect, incidental, special or consequential damages caused by using the information, or as a result of the risks inherent in the stock market. The information contained herein is based on sources we believe reliable, but its accuracy is not guaranteed. Horlbeck Capital Management and or affiliates may at times have a position in the securities described herein. The market commentaries are by Todd Horlbeck and express the opinions of Todd Horlbeck and not those of Cantella & Co. Complete information, including all research, is available upon request. Past performance is no guarantee of future results. Securities offered through Cantella & Co., Inc Member FINRA SIPC