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FEATURES MAIN

Does Extreme Stress Signal an Economic Snapback?

By ANDREW BARY

More than a decade's worth of equity gains has evaporated. But history suggests that stocks won't fall much further.

NOT MANY PEOPLE ARE JUMPING OUT OF WINDOWS on Wall Street or selling apples on corners, but investors are getting a bitter taste of what happened in the aftermath of the 1929 market crash.

The brutal 2008 bear market deepened last week as the Dow industrials fell 451 points, or 5.3%, to 8,046, despite a sharp rally Friday that lifted the benchmark average 494 points. The S&P 500 slid 8.4%, to 800, amid deepening fear about the global economy and financial system. Citigroup tottered at week's end after it plunged 60% in the five sessions to just \$3.77 a share.

At Thursday's low, both the Dow and S&P had erased more than a decade's worth of gains. If the markets end the year where they finished Friday, both the 39% drop in the Dow and 45% slump in the S&P would mark their worst yearly decline since 1931. The current bear market, which has brought the DJIA down 43% from its October 2007 peak of 14,164, now rivals any decline in the 20th century, save for the loss of 83% from the peak in 1929 to the market depths in 1932 when the index bottomed at just 41.

A philosophical Warren Buffett told Fox Business News Friday morning that slumps worse than this one have happened before, referring to the 1929-1932 crash. Buffett noted that markets and the capitalist system overshoot and that this seems to be one those times. He said the markets are in a "negative feedback loop" as bad news becomes self-reinforcing.

It's tough to say when the markets will bottom, but unless the world is entering an economic depression, history suggests that stocks don't have much further to fall. Save for the 1929-1932 crash, no downturn in the 20th century exceeded 50%. One of the many ironies about this year's setback was that it was largely unanticipated because major averages began 2008 selling for a seemingly modest 16 to 17 times projected earnings, versus a peak of 25 in 2000. It turned out that profit estimates for this year were way too high.

Bear markets since 1929 usually have been followed by fairly quick recoveries. The average time to recoup a bear-market loss has been 22 months, excluding the 1929-1932 collapse, according to AllianceBernstein, which examined the S&P 500's total returns (stock-price gain or loss, plus dividends). Based on prices alone, the Dow didn't recover to its 1929 peak until the early 1950s.

"Large market dislocations usually have been resolved pretty quickly," says Lewis Sanders, the chief executive of AllianceBernstein, the New York asset manager. "The only time that you had an extreme dislocation was the Depression itself." He notes that the average post-World War II recession has lasted less than a year. The markets often anticipate the end of a recession before it officially concludes. As Buffett wrote recently, "If you wait for the robins, spring will already be over."

Another encouraging sign is the shrinking value of U.S. stocks relative to nominal U.S. gross domestic product. At the market peak in 2000, stocks were valued at twice the size of the economy, but the relationship has adjusted this year to an estimated 59%, well below the long-term average of 79%. To get back to 79%, the S&P 500 would have to rise 36%, to 1,090. The relationship got as low as 40% in the late 1940s, when investors feared another depression, and in the inflationary 1970s.

Sanders says that many assets other than stocks, including commercial mortgages and junk bonds, appear to be priced for a depression. This is remarkable because as recently as 2007, these markets were priced for an economic boom. Not long ago, Barron's Roundtable member Marc Faber argued that there were "bubbles" in virtually all asset classes around the world.

Commercial-mortgage securities with triple-A credit ratings now yield 15% or more, while junk bonds yield an average of 20%. The junk market has collapsed this year, falling 32% after interest payments, by far the worst decline in its 25-year history, according to Merrill Lynch. So-called leveraged loans -- bank loans made to junk-grade companies -- yield 15% or more and trade for an average of 70 cents on the dollar.

Many pros argue that the best risk/return trade-offs lie not in stocks but in the credit markets, given the off-the-charts yields now available. With credit scarce and hedge funds under massive pressure to unwind leveraged trades in a wide variety of bonds, unusual market dislocations are cropping up, including an unprecedented relationship between risk-free Treasury bonds and interest-rate swaps, which are bank obligations. Thirty-year T-bonds almost always yield less than swaps because of their U.S. government guarantee, but they now yield a

because of their U.S. government guarantee, but they now yield a half-percentage-point more, an event that mathematical models would say is virtually impossible.

There have been almost no places to hide in this year's bear market, as value and growth strategies both have been bashed, unlike the situation after the market peak in 2000, when value dramatically outperformed other approaches.

Wal-Mart Stores (ticker: WMT) is the only one of the 30 stocks in the Dow that is higher this year and just 10 of the 500 stocks in the S&P are above water.

There has been some logic to the recent losses as credit-market woes have led to particularly severe declines in many industry groups with high leverage, including real-estate companies, casinos and financials. Real-estate investment trusts endured a terrible selloff lately, falling, on average, 28% since Nov. 13 and 60% since Jan. 1. Well-regarded REITs like Simon Property Group (SPG), Boston Properties

(BXP), Vornado Realty Trust (VNO) and AvalonBay Communities (AVB) now have dividend yields in the 7% to 10% range.

The "capitalization rate" on REITs has risen to 8%-to-10% from 4%-to-6% earlier this year. This measure is derived by dividing operating income by enterprise value, which is equity market value, plus debt. The rise in cap rates is bad news for leveraged investors who bought real estate in recent years because their equity probably is worthless unless market conditions improve.

FINANCIALS GOT WHACKED last week as Bank of America (BAC) declined 30%, to 11.47; Morgan Stanley (MS) was off 16%, to 10.05, and Goldman Sachs (GS) slid 20%, to 53.31. Morgan Stanley now trades at just 40% of its tangible book value of \$26 a share, while Goldman fetches 64% of its tangible book of \$82, after briefly falling below its 1999 IPO price of 53.

In the days when Goldman was a partnership, employees toiled for years to make partner and have the opportunity to get Goldman equity at book value. Now, any investor can buy into the company at a fraction of its stated net worth. Citigroup languishes at about half of its tangible book value. There are obvious risks in the financials, but it's rare for investors to be able to buy so many companies -- life insurers, property and casualty insurers, banks and brokers -- below book. Financials within the S&P 500 are down 67% this year.

It has been perilous to call a bottom in financials and the overall stock market this year, but history at least is encouraging.

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