Inside: why we believe, based on two studies we've made of the market's technical behavior, that a broad-based rally is under way for U.S. equities.

Why a rally now?

By Clara Basile
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The period from March, 2000, through October, 2002, has surely been among the toughest tests of investor confidence in the last 75 years. Nearly three years of uninterrupted losses have rivaled those of the most severe bear markets, including the depression years of the 1930's and the stagflation of the 1970's.

Why a rally now?

It is too soon to know whether the rally in the stock market since October 9 signals the end of the bear market that began in March, 2000. Such things are only known for certain in hindsight. Still, both technical indicators and fundamental factors now appear to be supporting prices despite the seemingly relentless decline of just two short weeks ago.

Certainly earnings have surprised on the positive side. Upside surprises at 61% of reported earnings are exceeding downside surprises of 12% by a 5:1 ratio. While year-over-year changes in earnings at positive 6% are not robust, they do show back-to-back gains on a quarterly basis – clearly an improving trend when the market was expecting much worse. Valuations are reasonable. While trailing P/Es still appear high, P/Es reflecting future earnings are modest at 14-15 times earnings. With interest rates under 2%, this translates into a market undervaluation of nearly 40% by some widely used measures.

Perhaps the most compelling evidence that the bottom is here, or near, comes from two studies we've made of the market's technical behavior. The first looks at the current position of stocks when compared with other post-mania declines. The second looks at the historical performance of U.S. stocks in the context of "the 4-year cycle" over the last forty years.

Before looking at the first study, we'll define the term "secular trend." When discussing the secular trend, we are referring to a very long-term trend that spans several business cycles. It is also referred to as a "generational trend."

In the United States, there have been three secular bull markets: the 1920's until the Crash of 1929, the post-World War II boom from 1942 through 1968, and the most recent bull, 1982 through 2000. The secular bear markets include: the Great Depression, spanning from 1929 through 1942, the stagflation years of the 1970's that spanned 1968 through 1982, and arguably, the current period that began in March, 2000.

For the purposes of this analysis, we studied the post-bull market periods to get a handle on how far the current decline might travel. We looked at the duration of the declines, i.e., how long did the market fall before terminating the first phase of the bear market, and the magnitude of the fall, i.e., how much did it go down before a meaningful (at least several months') rally ensued? Our findings are detailed in Table 1. We compared both the current readings on the Nasdaq and the S&P500 to those of the Dow Industrials in past periods.

What we conclude is that the current bear market decline is already longer and deeper than any in history except that of the Great Depression, which was only one month longer than the decline since March, 2000. Most relevant to the current market analysis is the fact that in all cases the best rally of the subsequent decade came in the first two years following the initial low.

Whether we have seen the lows to the first phase of the secular bear or they happen over the next month or two, we believe the odds are now very high that returns will be positive over the next one to two years. While investors are feeling demoralized, we do not think this is a good time to lose heart.

Our analysis shows us that stocks are *now* attractive *even* after factoring in all the uncertainties in the current environment. Setting aside the prospects for returns over the next 10 years, we believe that the next major move should be a rally. When compared with other asset-class alternatives like cash currently yielding less than 2% and treasury bonds now yielding less than 5%, we believe that the expected return for stocks should be at least as good and probably better.

TABLE 1: Historical Analysis of First Bear Phase in Secular Bear Markets

Secular Trend Dates	First Bear Phase	% Decline of Bear*	2-year return per annum (after bottom)	5-year return per annum (after bottom)
1929-1942 (Dow Industrials)	34 months (1929-1932)	-89%	+47%	+37%
1972-1982 (Dow Industrials)	26 months (1972-1974)	-47%	+34%	+7.4%
1989-2002 (Japan's Nikkei)	33 months (1989-1992)	-64%	+23%	+5%
2000-2010?? (Nasdaq Comp)	32 months (2000-2002??)	-78%	??	??
2000-2010?? (S&P500)	32 months (2000-2002??)	-51%	??	??

Source: Avalon Capital Management Historical Data: Thompson Financial * All changes price only

The second indicator is a historical analysis of stock market prices that shows that the stock market has made a major bottom every fourth year since 1962. The table below lists the dates of the market bottoms and the subsequent rallies on a six- and twelve-month basis over the last 40 years. The so-called "four-year cycle" has been in operation in both secular bull and bear markets. The returns have always been positive on both a six- and twelve-month horizon after the bottoming of the 4-year cycle, averaging 23.48% and 32.78%, respectively. As Table 2 illustrates, in more than half the instances, the greatest portion of the advance occurred in the first six months. The table also shows that the underlying secular trend, either bull or bear, did not influence the results.

TABLE 2: Historical Analysis of the 4-year cycle in U.S. stocks since 1962

Date of 4-year cycle bottom	S&P500 6 months later	S&P500 12 months later	Quality of Secular Trend
June, 1962	+17.3%	+31%	Bull Market
October, 1966	+19.2%	+20.97%	Bull Market
May, 1970	+16.16%	+34.83%	Bear Market
December, 1974	+41.87%	+37.27%	Bear Market
March, 1978	+17.91%	+19.99%	Bear Market
August, 1982	+27.02%	+44.15%	Bull Market
September, 1986	+28.12%	+43.42%	Bull Market
October, 1990	+25.62%	+33.5%	Bull Market
November, 1994	+19.23%	+36.98%	Bull Market
October, 1998	+22.34%	+25.68%	Bull Market
October, 2002	????	????	Bear Market
Average	+23.48%	+32.78%	

Source: Avalon Capital Management Historical Data: Thompson Financial * All changes price only

Each of these methods is relevant for estimating the current prospects for the market. The first method encompasses the steepest declines in market history of which the current period is a subset. The second shows a persistent 4-year periodicity in the market spanning 40 years and varied investment environments on a regular 4-year basis. A low in the current time period would extend that pattern.

If laws of physics can be applied to the behavior of stock prices, can a market that has fallen from such towering heights be so different from a ball falling from a tall building? And, if the first bounce is usually the biggest before trailing off into a new equilibrium, we believe likewise the odds are good that the next few months should reward investors who do not lose their nerve.

While our analysis is based upon our best professional judgments, the markets' past turnarounds do not precisely indicate when current market conditions will change.

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