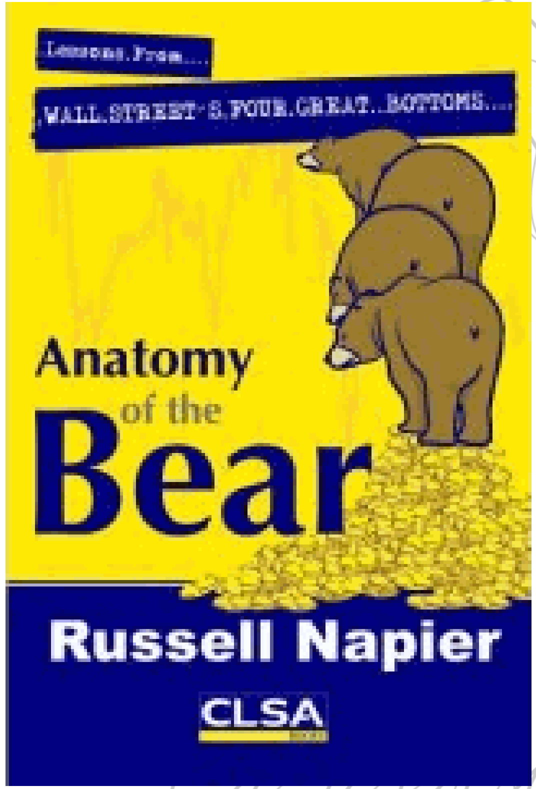
Anatomy of the Bear – Lessons from Wall Street's Four Great Bottoms Russell Napier © 2005

Over the last two decades, about 60 people have been killed by bear attacks in North America. Of far greater threat are financial bear markets that can "shred a portfolio and severely damage your wealth". This book is a field guide to the four biggest bear markets in the last 100 years which bottomed in Aug 1921, July 1932, June 1949 and Aug 1982.

This work optimistically focuses on identifying the factors that may help us time when the bottom is reached – that being the best time to buy stocks in history.

Napier studied 70,000 Wall Street Journal articles two months before and after bottoms identified where the market aggregate "q-ratio", or ratio of stock prices to replacement value of company assets*, was below 30%*. This highly researched work provides an outstanding practical history of the US market for those interested.



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*While the Dow Jones index is at 10,500, the current US market q ratio is about 0.5 below long term average of 0.6, P/E is ~ 10

The four great bottoms in context of the …

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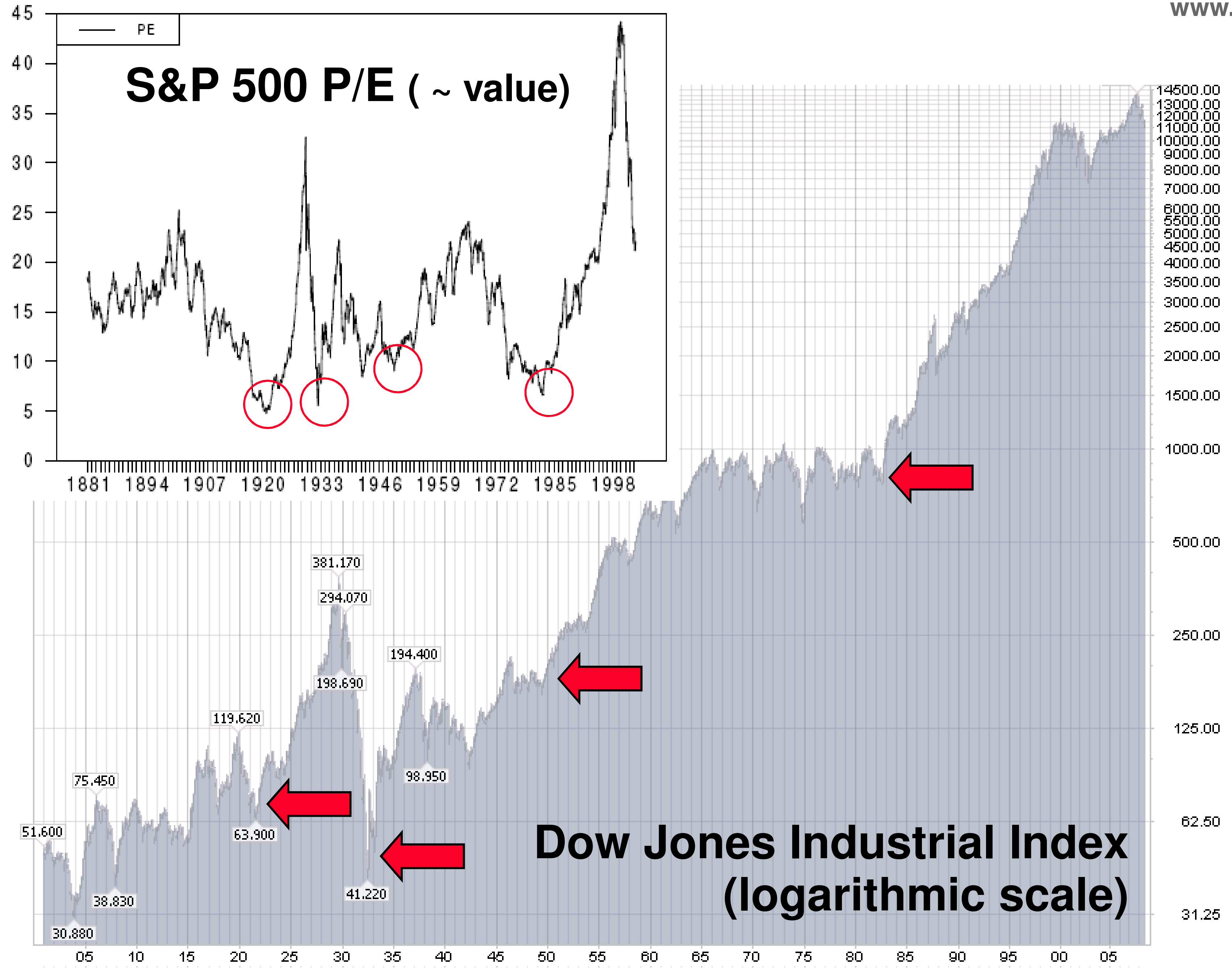
Executive Summaries



Source: stockcharts.com,

The first post WWI bottom

To the August 1921 bottom
US economy boomed while supplying resources to war torn Europe However growth in company earnings failed to keep up with overall economy Investors saw little capital return (excl. generous dividends) and became less interested in stocks Government debt which rose from \$1b to \$24b competed for capital Market slumped as peace broke out and deflation took over from war time inflation Decline reversed as prices stabilised

"US equities traded below fair value from 1917 to 1926. How was an investor to know that the summer of 1921 was the opportune moment to invest?

There was a combination of signals suggesting it was time to buy: improving demand at lower prices for selected goods particularly autos, commodity price stabilisation, improving economic news being ignored by the market, rising volumes on a strong stock market, falling volumes on a weak stock market, a rising short interest; a final fall in equity prices on low volumes; reductions in Fed controlled interest rates; a rally in the gov't and corporate bond market …"

The infamous bull and bear markets of the 20s & 30s

From August 1921 the DJIA rose 500% from 64 to 381 by September 1929, until crashing downwards in a series of steps finally bottoming 89% lower to 41 on July 1932

The rise was driven by increasing company profits in a low inflation environment

Innovation, including electricity, petro-chemicals and the automobile, raised productivity

This was followed by a sudden expansion of consumer credit which was later directed to market speculation

Rising interest rates eventually crushed this like a "sledge hammer"

By April 1930 market recovered 52%of the decline from the 1929 peak (an ordinary recovery)

Fell again following three banking crisis waves (some emerging from farm lending)

Fed slow to extend credit until 1931 in part due to gold reserving / currency stability issues

Crash quickly turned over-valued equities into under-valued equities (q ratio 1.5 to 0.3)

Recovery began as commodity prices picked up following more than three years of decline

"When the market seemed so stunned as not to respond to good or bad news a subtle shift [for the better] began"

"In 1918 America honoured its dead, in the 1920s they mortgaged them and by the 1930s foreclosed on them"

Post WWII bottom and the following long boom

To/from the June 1949 bottom
1934 to 1949 saw series of short-term booms and declines ("false dawns") Government was large part of economic activity (post-depression recovery projects, WWII economic controls) Equities traded at discount and many investors were (war) bond holders Post-WWII, 10m Americans returned to work and consume. US companies' competitors in Germany destroyed. By 1949 conditions stabilised sufficiently to launch a long boom market which lasted until 1968 when inflation broke out Cold war provided some confidence that only small wars would emerge; pension funds embraced equities

"As it happened in 1921 and 1932 US equity prices stopped falling when they reached a 70% discount… All the same signals were positive as in 1921, with the exception that with Fed interest rate policy constrained in 1949, it was a reduction in credit controls that indicated the bear market was in its final phase"

"A bear market is marked by a final decline on no [little] volume, rather than high volume" [ie. bear mkt's end on a whimper]

"a market that does not decline on bad news was a positive indicator of a rebound in 1921, 1932 and 1949"

"investors buying equities on the 1st sign of easing monetary policy in March 1949 were to see the DJIA decline a further 10%"

The 4th 1982 (and 5th 1974) great bottom

To the August 1982 bottom
Share market moved mainly sideways over a "14 year period of malaise" preceding '82 (included the 5th great bottom in 1974)
Inflation was rampant which persisted even during the downturns ("stagflation") broken only by rising interest rates
Prolonged bear market reduced equities to good value (from P/E 25 to 10, q ratio of 1.06 to 0.38 from '68 to '82)
Market recovery preceded economic recovery and coincided with international financial crisis (Mexico, Latin America)

"With Nov 1929 and May 1980 in mind, investors should tread warily, but be prepared to buy cheap equities when a reduction in the discount rate signals the beginning of the end for a Fed war on inflation"

"bottom again marked by the absence of a final slump in stock prices on high volumes …higher volumes at higher levels confirms the bear market is over"

"those waiting for evidence of improvement in corporate earnings would have kept their powder dry until 2Q 1983. At each of the bottoms the nadir for earnings has come some months after the bottom for equities (four to seven months)"

Summary observations

Great bottoms are the end of a slow transition when equities move from being over-sold to under-priced (average 14 years excluding 1929 rapid change)

Occur during economic recessions brought on usually by rising interest rates used to fight inflation (except 1932)

A return of price stability following general deflation (except for 1982 where only commodity prices fell) generally signals the bottom of the bear market. Bear markets end on a “whimper” not a “crash”.

Other signals include bonds rallying (federal then corporate) as yields and interest rates fall and the auto industry picks up. Inventory levels will be low and their will be a rising demand for products at lower prices.

Good economic news increases but is ignored – some will bang the drum for equities while others will wrongly highlight worsening fiscal positions. Corporate earnings can still continue to decline past the bottom. There will be a large number of investors still shorting.

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