

# E.Q Trendwatch™

## The anatomy of a Bear

January 2008 will go down as one of the most damaging starts to a New Year ever in market history. In reality though, January was simply the continuation of a bear market that began in stealth some 6 months ago. In three short weeks, January's decline yanked back all the gains equity markets had "made" since late 2006.

Technically a bear market is registered when a market contracts by more than 20%. On this metric, more than half of the world's biggest stock indexes fell into a bear market in January as mounting concern about a U.S. recession dragged down banking and retail shares across Asia, Europe and Latin America. The MSCI World Index had its steepest decline since 2002, leaving benchmarks in France, Mexico, Italy, India and 35 other countries at least 20 percent below their recent highs. Once again investors are learning the hard way that geographical diversity is practically useless in a bear market.

Mirroring the world market declines, the Canadian market index (TSX) broke below the long-term support it held since the last business cycle bottom in October 2002. As shown below, the blue line (10 week moving average) broke down through the red (40 week moving average) below.



**Cory Venable CIM, FCSI, CMT**  
Technical Market Analyst



**Danielle Park LL.B., CFP, CFA**  
Portfolio Manager

**Venable Park Investment  
Counsel Inc.**

Venable Park Investment Counsel Inc.  
  
[www.venablepark.com](http://www.venablepark.com)

33 Clapperton St.  
Barrie ON L4M 3E6  
Tel: (705) 792-3991  
Toll Free: 866-792-3991  
Fax: (705) 792-3992

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Simultaneously a similar downside breach came to the US broad market as shown in this S&P 500 chart below:



With the bear trend confirmed, the bull market that began from the bottom in 2002 has ended.

### ***How long and how deep will this bear market be?***

While this is the multi-billion dollar question, admittedly it is not one that we nor anyone else can answer in advance. Time will tell. In the meantime, we have only historical precedents to review. The average Bear market of the last 100 years has lasted 9-11 months with an average decline of -26% (S&P 500). Recessions have been a frequent (some would say normal) conclusion to past business cycles, especially those that have ended with a major real estate decline. Where business cycles have ended with economic recession, the average stock market decline has been closer to -45%. This is not us making a forecast. However, a decline such as this would not be unusual given various risks at play in the present economic contraction.

### ***What should we expect in week to week market action as this bear trend plays out?***

It is crucial for investors to understand the way that market cycles typically evolve. Failure to understand market cycles is the number one reason that people hold risk assets well past market peaks, all the way down through bear market declines, to finally abandon stocks near market bottoms.

In order to move opposite to the self-destructive behaviour of most investors, we need to understand the anatomy of a bear market-- how it moves, and what we might expect over the coming weeks and

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months. ***The first thing to note is that even within an ongoing bear market we should expect big gaps down followed by dramatic rallies.*** So it is likely that we will see a few days or even weeks of up days as this bear grinds on.

We must be aware that these “false rallies” are likely to be fleeting and not alter the primary bear-market trend that has now been established. Expect many optimistic market commentators to prematurely recommend that people “buy the dips” all the way down through this part of the cycle. Many will say that each new low brings a “buying opportunity”. But since these same commentators never recommend that anyone sell or avoid equities near market peaks, most of their followers will not have cash available to take advantage of these buying opportunities. There will hence be more sellers than buyers.

Its worthy to note that the last bear (2000-2002) which took world markets down by some –45%, included three separate rally segments where markets roared back 20% before collapsing again to a final bottom. As exciting as these interim rallies can seem on the screen, they are notoriously dangerous and must not be allowed to suck disciplined investors back into the fray.

In the meantime, it is most likely that we will continue to trade back and forth within a downward channel as shown in the below chart of the TSX since October 2007.



At Venable Park we will continue to diligently monitor and measure the overall market trends daily, weekly and monthly as this cycle unfolds. So long as the trend continues in the downward channel, capital preservation necessitates that we stay out. But we will also be watching for the turn in several leading sectors such as US financials, semi-conductors and technology. As is traditionally the case,

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these sectors led the market into this downturn and to date have recorded some promising losses. Semi-conductors historically have led the overall tech sector. Tech traditionally leads the overall market. The semi-conductor index recently fell to a six-year-low and is currently at the value it reached in the 2002 market low! How far the overall market follows this lead remains to be seen.

### ***Congratulations to our clients***

We would like to take a moment here to recognize the patience and resolve of our clients. You have stuck with our discipline through the roaring, reckless days of the past market peak. When market headlines and acquaintances may have seemed to be racing on without us, you stood pat. You let us do our job. You let us keep you safe. You are real life examples that people can control their emotions and they can control their responses. This market correction has been a long time coming. It has been a long-slow emergency. We know that surging price risk made us leave early. And this has not been easy. But remember this. There is nothing easy about buy and hold either. Investors who have no sell discipline stay fully invested all through the peak of every market cycle. They get all of the gains at the top and all of the losses that follow. There is nothing easy about losing 30% to 40% of your life savings when bear markets come. We get to be early or we get to be late. Staying too late has profoundly harsh and lasting impacts on people their savings and their happiness. You have not lost money as the rest of equity investors have now since 2006. Your capital is in tact. You will have cash to take advantage of the coming buying opportunities. Now is your time to reap the benefits of discipline and self-control. It couldn't happen to a more deserving bunch of people if you ask us. We are proud to work for you. We are honoured by your trust. With you as our purpose we are inspired to this work.

### ***A Closing Quote:***

“...early is a portfolio manager’s best maxim. In this case it has nothing to do with birds getting the worm or being the first runner out of the starting blocks, but more about being positioned when markets move into crisis mode. Risk assets in a highly levered, finance-based global economy can move so quickly to the downside that by the time you hear the birds chirping or see the starter’s gun smoking the race may be already half over. Admittedly, there’s a price to be paid for sitting out the frenetic last thrust of any bull market. In stocks, it comes in the form of being labelled old-fashioned or out of touch as Warren Buffett was in the dot.com craze or even in the first half of 2007. In bonds, it shows up as lost carry when yield spreads compress and high quality government bonds are shunned for derivative structures offering double-digit levered rewards. But when risk markets perceive a change in the wind—a turn in profits, a potential recession, and most importantly as was the case in mid-2007, an implosion in the pyramid scheme, chain letter driven structure of modern finance—then you’d better be already positioned. Exit doors lock automatically as illiquidity and the psychological frailties of the human mind prevent quick action in order to preserve capital.”

--Bill Gross, Director or PIMCO

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