

# the Whitepaper

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**Burt White**  
Chief Investment Officer  
LPL Financial

## Highlights

All over? Not quite yet.

- The market is showing signs of warming up! The good is getting more frequent and the bad less worse. Still, we are not ready to declare that “it is all over”. The market is still in a down trend in its attempt to find its bottom and will likely revisit lower levels than today’s in the near term.

Key metrics provide signs we are shifting to recovery:

- One of the biggest bubbles that has emerged recently is not a market segment or style of investments, but rather is a Bubble of Uncertainty. Slowly, the news is becoming clearer about the state of the financial services industry and the many government bailout and stimulus plans so this bubble is beginning to fade.
- For a recovery to take hold, we have to see that both the credit (bond) and equity markets are seeing improvement.

What to do?

- We would not recommend chasing after this latest bear market rally, especially considering it is already advanced some 20% from intra-day low to intra-day high. We continue to recommend cautious optimism, with a firm eye on portfolio construction, diversification, and risk control.

## Despite Encouraging Signs, Don’t Confuse Oversold with “It’s All Over”

While I tried with all my might to avoid the overdone clichés of the simultaneous arrival of spring (March 20) and better performance from the market, I just could not resist. It seems that Mother Nature has a cruel sense of humor. She always seems to throw a string of beautiful spring days out of no-where at the end of a long winter just to tempt us into thinking that the frost and cold are all long gone. While here in Boston warm weather is certainly just around the corner, don’t pack up the mittens just yet, as usually Mother Nature has a few more cold days up her sleeve.

Similar to the weather, LPL Financial Research has observed that the market is showing signs of warming up: the good is getting more frequent and bad less worse, which is creating a backdrop for a bottom and a stage for recovery. With the recent market action turning more positive, sparked by the double-digit rally in stocks over the last week, could we have seen the worst? Is this bear market nightmare over and is it time to sound the “all clear”? Can we finally put the snow shovels away and look forward to the green sprouts of new growth?

Not yet, we are afraid, but we may be close. Remember that there is a big difference between oversold and “it’s all over.” Oversold is simply a trader’s term that describes a market that has fallen too much, too fast. This market was oversold leading up to our recent bounce. Since the recent high on February 9, 2009 at 875, the market dropped 24% during the next 20 trading days to hit an intra-day low of 667. The period was marred with 5 days that declined in excess of 3% and included a brutal stretch of 13 down days out of 16. This “too much, too fast” action resulted in oversold conditions and has set the stage for a possible bear market bounce. Perhaps even a big one. Bear market bounces commonly exceed 20% and in just over a week, this one is up about 20% as measured by the S&P 500.

Despite the recent market action breaking a long string of negative returns and the encouraging signs that are beginning to be more frequent on the economic front, we are not ready to declare that “it is all over.” We continue to believe that the market is still attempting to find its bottom and will likely revisit lower levels than today’s in the near term. The reason for the bear market continuation is not the balance between good and bad news, which has swayed more positive as of late, but rather the abundance of missing answers to the market’s key questions. That said, we are encouraged

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This Bubble of Uncertainty is working like an eclipse, dominating the focus of the market and casting its dark shadows over the improving (or less worsening) economic news. It is our opinion that this bubble has peaked but, unlike the end of most bubbles, this one will experience a slow deflation rather than a bursting.

For a recovery to take hold, we have to see that both the credit (bond) and equity markets are improving, simultaneously, which would indicate that the real catalysts for market and economic progress are taking hold.

that this bottoming process is progressing well and believe that the stage continues to be set for the market to begin to shift towards a long-term recovery, not just an oversold, bear market bounce.

So, the questions remain: when will this shift to recovery occur and what are the key metrics that would identify its arrival?

## **Bub•ble•ol•o•gy (bûb'əl-òl-ə-jè) noun, 1. The science of studying bubbles**

To be a great investor, one must be schooled in the science of bubbleology. Markets always have bubbles, which are excessive imbalances of fear and greed. These bubbles create massive dislocations, ignore fundamentals and common sense, and always deflate. Understanding where the bubbles are located and how big they can get before popping is the key to investors establishing a strategic plan of investing.

It is our belief that one of the biggest bubbles that has emerged recently is not a market segment or style of investments, but rather is a Bubble of Uncertainty. There are always unanswered questions facing the market, but over the last six months, the future has become far fuzzier.

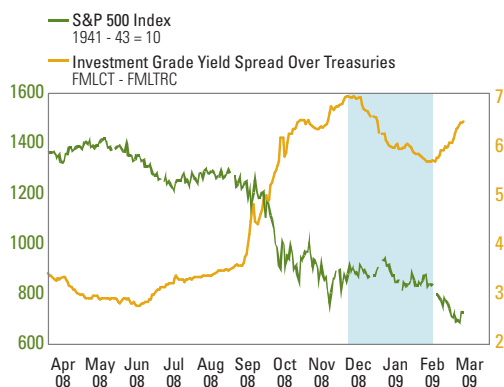
This Bubble of Uncertainty is working like an eclipse, dominating the focus of the market and casting its dark shadows over the improving (or less worsening) economic news. It is our opinion that this bubble has peaked but, unlike the end of most bubbles, this one will experience a slow deflation rather than a bursting. Slowly, as news becomes clearer about the state of the financial services industry, details of the many government bailout and stimulus plans, as well as company earnings are unveiled and clarified, the Bubble of Uncertainty will fade.

The recent bounce, which was largely a reaction to oversold levels, was in part driven by the market viewing favorably that uncertainty is fading. While many questions still remain, recent days have seen light shed on the status of key banks and details around key government programs like the TALF and TARP2. Senior officials from the Obama administration have thrust themselves uncharacteristically into the public's eye in an attempt to fill the clarity void, magnified by Fed Chairman Ben Bernanke granting a 60 Minutes interview and President Obama's scheduled appearance on the Tonight Show. Clarity was further garnered by the significant actions outlined by the Federal Reserve yesterday (March 18) that outlined a plan to remove toxic assets out of the market, inflate the economy and drive mortgage rates lower. As the bubble continues to deflate, the focus will shift to the increasing pace of good news and the declining velocity of bad news, which could allow the market the platform to begin its Road to Recovery.

## **Stocks and Bonds have to Agree that Things are Improving**

For a recovery to take hold, we have to see that both the credit (bond) and equity markets are improving, simultaneously, which would indicate that the real catalysts for market and economic progress are taking hold. So far, this

Measuring Risk in the Stock & Bond Market  
S&P 500 Returns and Investment-Grade  
Yield Spreads



Source: S&P, Haver Analytics, LPL Financial

We have yet to see stocks and bonds agree on the catalysts and timing of good (or improving) news. An illustration of this in the blue box from the middle of December 2008 through the first week of February 2009 saw the bond market significantly tighten spreads, reflecting a desire to assume greater risk.

has not happened. While both markets have been in lock-step as it relates to concern over economic conditions, we have rarely seen both agree on improvements. This is vital for a recovery to begin.

Refer to the nearby chart. The green line, signifying stock performance, and the yellow line, illustrating yield spreads for investment-grade corporate bonds over Treasuries, should be moving in opposite directions if both markets are viewing risk similarly. For stocks, a reduction in risk means that investors are willing to pay higher valuations for stocks and thus drive performance higher. For bonds, risk reduction means a lowering yield spread, which means investors require less income over relatively risk-free Treasuries to assume default risk.

Notice that for most of the periods shown in the nearby chart that yield spreads have widened while stock performance has declined (the green and yellow lines moved in different directions), reflecting that the two markets were in alignment regarding risk. But this has been predominately during declining markets when there was downside market risk. As such, while it has been commonplace for stocks and bonds to be on the same page as it relates to bad news, we have yet to see both agree on the catalysts and timing of good (or improving) news.

An illustration of this is the period outlined in the blue box in the nearby chart, which was the middle of December 2008 through the first week of February 2009, where the bond market saw a significant tightening of spreads, reflecting a desire to assume greater risk. However, over the same period, stocks declined, indicating that equity markets had a differing view. The same can be said for the action in this latest oversold bounce, as stocks have rallied, but credit spreads have not. Until these two powerful markets begin to both see the case for a recovery concurrently, it is highly unlikely we will have a sustained advance.

THE LAST FIVE BEAR MARKET RALLIES

Date	Beginning (measured by intra-day low)	End (measured by intra-day high)		Duration (Days)	Return
	S&P 500 Level	Date	S&P 500 Level		
7/15/2008	1200	8/11/2008	1313	20	9.4%
10/28/2008	845	11/4/2008	1008	6	19.3%
11/21/2008	741	12/8/2008	918	11	23.9%
12/22/2008	857	1/6/2009	943	10	10.0%
3/6/2009	667	3/18/2009	803	9	20.8%
<b>Average</b>				<b>11</b>	<b>15.8%</b>

Source: FactSet, LPL Financial  
Past performance is no guarantee of future results.

## While Waiting for the Recovery, What is the Best Way to Invest in this Bear Market Bounce?

In the course of any bear market, oversold reversals are common and can be very powerful. The real question is whether they are investable, as opposed to just tradable. While bounces can vary in duration and magnitude, ranging from a few days to a multi-week rally, participation requires identifying a short-term bottom, rapidly trading, and then identifying the end of the advance to reverse the trade. This is certainly more of a market-timing and trading strategy than it is an investment strategy. As such, full or even partial participation in bear market rallies are often difficult for investors to capture.

As such, we would not recommend chasing after this latest bear market rally, especially considering it has already advanced in excess of 20% from intra-day low to intra-day high. We continue to recommend cautious optimism, with a firm eye on portfolio construction, diversification, and risk control. We believe the proper positioning is to maintain a neutral to slightly lower equity

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If your portfolio is overweight equities, have a plan to move to neutral equity beta by selling into a bear market bounce.

If your portfolio is underweight stocks, do the opposite, look at adding investments opportunistically to get to a neutral to slight equity underweight at the low end of the range.

risk profile (relative to the benchmark), while allocating more aggressively within fixed income opportunities. We continue to like investment-grade Corporate Bonds, Bank Loans, Preferred Stocks and to a lesser degree High-Yield Bonds. The equity market will likely continue to not be directional in nature (up or down) but rather volatile (up and down).

If your portfolio is overweight equities, have a plan to move to neutral equity beta by selling into the bear market bounce. Given that bear market bounces have historically ranged from 10 to 50%, with the majority in the 10 to 35% range, look for a good point to trim between now (about 785) and 900.

If your portfolio is underweight stocks, do the opposite, look at adding investments opportunistically to get to a neutral to slight equity underweight at the low end of the range in preparation for the impending market bottom and eventual recovery. We would not recommend trying to haphazardly pursue this bear market rally, but rather be prepared to opportunistically add to equities if the market retests. Look to add equities between 700 and 750, which appears at this time to be an attractive entry point.

However, this bear market bounce could in fact end up being a multi-week or even multi-month move. We will get that sign if the market continues to advance, hold and adequately retest various support levels, with the most meaningful being 741 and 830, as well as the 50 day moving average. If this rally does prove to be a longer term investable event, a strategy to increase beta before a retest may have to be re-examined.

While cold weather and challenging markets may still be with us for a while longer, as the good news keeps getting more frequent, the bad news less worse and the Bubble of Uncertainty fades, look for warmer investment temperatures around the corner. Keep the mittens and snow shovel handy, but it is not too early to start planning for spring.

## IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide or be construed as providing specific investment advice or recommendations for any individual. To determine which investments may be appropriate for you, consult your financial advisor prior to investing. All performance referenced is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

High yield/junk bonds are not investment grade securities, involve substantial risks and generally should be part of the diversified portfolio of sophisticated investors.

The market value of corporate bonds will fluctuate, and if the bond is sold prior to maturity, the investor's yield may differ from the advertised yield.

Beta measures a portfolio's volatility relative to its benchmark. A Beta greater than 1 suggests the portfolio has historically been more volatile than its benchmark. A Beta less than 1 suggests the portfolio has historically been less volatile than its benchmark.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise and are subject to availability and change in price.

Stock investing involves risk including loss of principal.

There is no guarantee that a diversified portfolio will enhance overall returns or outperform a non-diversified portfolio. Diversification does not ensure against market risk.

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