

Stock Market Outlook: Where to From Here?

Since last fall's financial panic, stock investing has been nerve-racking. From its November 2008 low, the S&P 500 gained +24% through mid-January 2009, fell back -28% to a new low in March, then recovered +36% through the end of the second quarter—by far the strongest rebound yet.ⁱ From here, stocks could again fall significantly, but in our view it becomes less and less likely the longer the rally is sustained. At this juncture, we believe long-term investors are best served maintaining their exposure to stocks and coping with market volatility.

Bounces off market bottoms historically have been fast and huge—if the current rally holds up, it could prove the point emphatically. Why do we believe this period is almost over? In brief, just look at history. From the October 2007 peak to the March 2009 low, stocks fell -57%ⁱⁱ—more than most bear markets (as Exhibit 1 shows).

Exhibit 1: Last 12 S&P 500 Bear Markets

Start	End	Months	S&P 500 Change
09/07/29	06/01/32	33	-86%
03/06/37	04/28/42	62	-60%
05/29/46	06/13/49	36	-30%
08/02/56	10/22/57	15	-22%
12/12/61	06/26/62	6	-28%
02/09/66	10/07/66	8	-22%
11/29/68	05/26/70	18	-36%
01/11/73	10/03/74	21	-48%
11/28/80	08/12/82	20	-27%
08/25/87	12/04/87	3	-34%
07/16/90	10/11/90	3	-20%
03/24/00	10/09/02	31	-49%
AVERAGE		21	-38%

Source: Global Financial Data; price index returns

In our opinion, whether the market is down a little or more ahead, any remaining downside will likely be small compared to the potentially massive returns of nascent bull markets (as Exhibit 2 illustrates on the next page). Based on our research there are no exceptions to this in the history of the S&P 500. We feel this time should be no different. Though increasingly

unlikely, the unfortunate but ever present question remains: Will there be more down before up? Our prescription is the same in either case. Stock investors should be in the market now to ensure participation in future upside. We believe jumping in and out of stocks in an attempt to time things perfectly creates too big a risk of getting whipsawed and missing that upside.

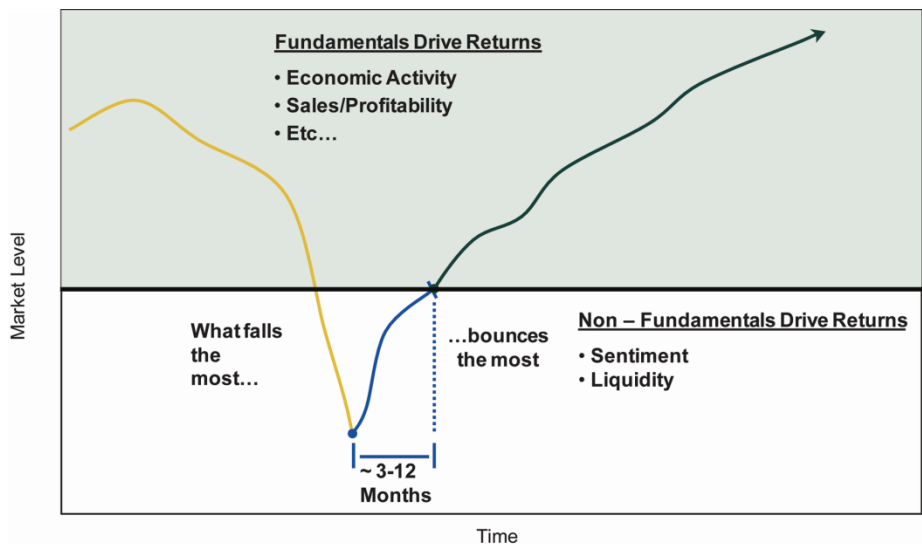
Exhibit 2: Last 12 S&P 500 Bull Markets

Start	End	12-Month Returns From Bottom	Bull Duration	Total Bull Return
06/01/32	03/06/37	121%	57	324%
04/28/42	05/29/46	54%	49	158%
06/13/49	08/02/56	42%	85	267%
10/22/57	12/12/61	31%	50	86%
06/26/62	02/09/66	33%	43	80%
10/07/66	11/29/68	33%	26	48%
05/26/70	01/11/73	44%	32	74%
10/03/74	11/28/80	38%	74	126%
08/12/82	08/25/87	58%	60	229%
12/04/87	07/16/90	23%	31	65%
10/11/90	03/24/00	29%	113	417%
10/09/02	10/09/07	34%	60	101%
AVERAGE		45%	57	164%

Source: Global Financial Data

Perfectly timing bear market bottoms is particularly difficult due to their characteristic “V” shape. High volatility and steep losses create the first half of the “V.” Exactly when and how the new bull market starts is impossible to know, but in our view it is likely to begin with a large bounce from the bottom (the right side of the “V”), as shown in Exhibit 3 on the next page. The most recent rally is an excellent example of how swiftly stocks can turn.

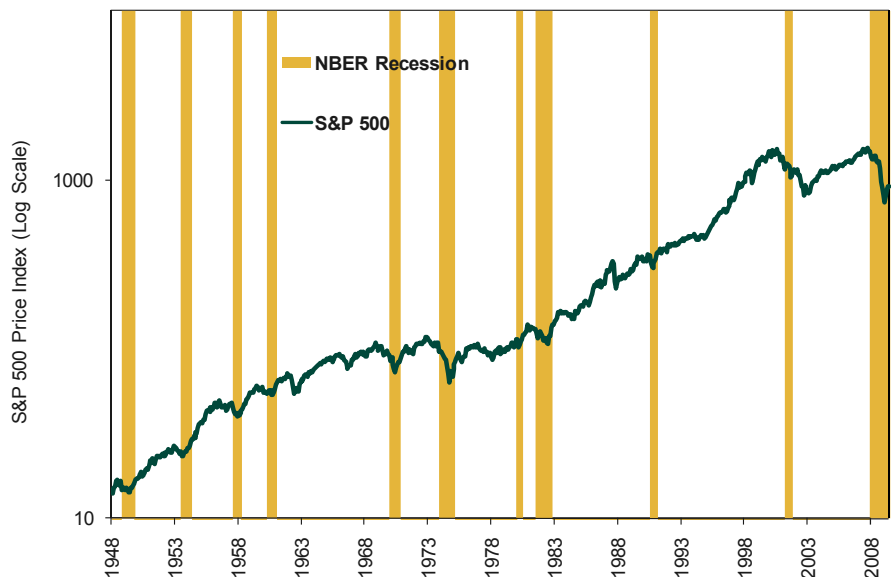
Exhibit 3: Generic “V” Shape of a Typical Bear Market Bottom



For illustrative purposes only. Not drawn to scale. Not to be interpreted as a forecast.

Many investors will wait for the economy to improve before investing in stocks again. But economic indicators look backward, only showing a recession has ended after the fact. Markets, on the other hand, don't wait for improved economic data, they anticipate it. Exhibit 4 below shows past bear markets have almost always begun their recovery well before the associated recession has ended.

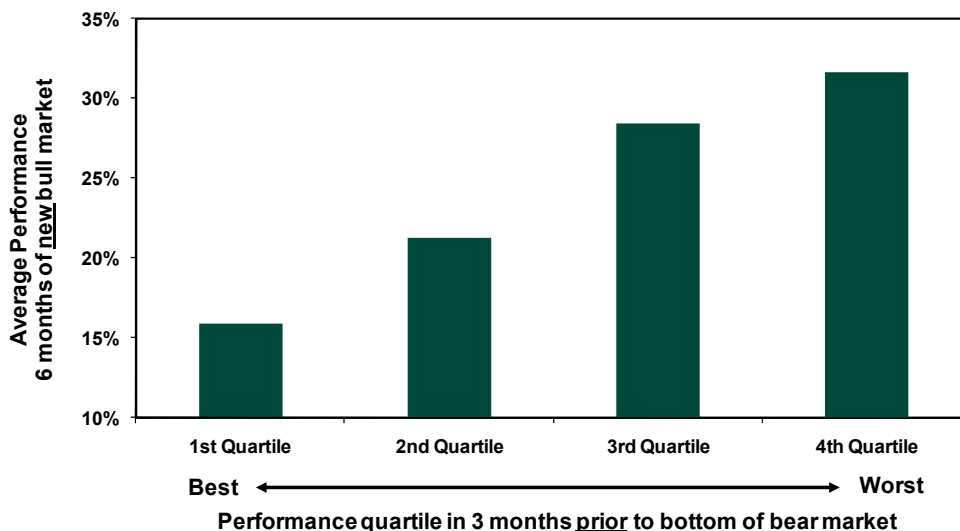
Exhibit 4: Markets Recover Before the Economy



Source: National Bureau of Economic Research (NBER), Global Financial Data

It's also important to favor the sectors most likely to outperform. As Exhibit 5 illustrates below, most categories that get hurt the most during the final stages of bear markets usually bounce back disproportionately more in the initial burst upward. So, beyond just choosing to invest in stocks, beating the market will require judging which sectors are best positioned to take advantage of market conditions going forward.

Exhibit 5: The Hardest Hit Bounce the Highest



Source: Global Financial Data, S&P 500 industry returns

In similar times of uncertainty, there will always be those saying “it’s different this time” and “stocks will never recover.” It always feels different “this time” but never is. Every bear eventually gives way to a new bull. We believe being fully exposed to stocks now ensures a full capture of that powerful upswing.

ⁱ Source: Thomson Datastream

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