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Stocks Rallied Big During The Depression Too

Robert Lenzner 04.03.09, 8:35 PM ET

Easing the banks' mark-to-market rule--another federal gift for Wall Street--though muddy and hard to evaluate, is instant elixir for investors. It will sweeten bank earnings and lend an aura that the Zombies are less Zombie-like.

Rallies cause investors' hopes to spring eternally. So, will the 20% rebound in stock prices keep going? A pile of money and agitated nervous systems can hope for more retracement after the onset of record oversold conditions. A move of 50% off of the bottom for the S&P 500 would take us back to 1,000. That would still represent only a 37.2% recovery of the loss from the 1,550 peak less than two years ago to the numerically demonic low of 666.

We do have precedent for such an explosive upside. Look at 1938, when there was a comeback of 60%. Nice, if it happens, but read carefully, that was the high for years and years.

Here are some more history lessons. Between September 1929 and June 1932, in the midst of the Great Depression, there were nine rallies of 15% or more. The average rally was around 15 days--sound familiar? The present rally, which began last month, is in fact the fourth rally of 15% or more since the bear market began in October 2007.

Technicians love to get out their charts and underscore moves in stock prices most investors have forgotten. From 1969 until early 1970, there was a sickening drop in stock prices as the conglomerate bubble burst and interest rates began to climb. Then, from the bottom in early 1970, the Dow industrials rose very near their former peak in 1971. There was to be more hell to pay.

From December 1972 until September 1974, the Dow Jones industrial average sank a sickening 40.4% as the nation tried to cope with Watergate and an OPEC oil embargo that quadrupled the price of oil from $3 a barrel to $12 a barrel. These were terrifying days when the middle class was losing purchasing power.

From December 1974 through June 1975 the Dow rallied back from below 600 to the 1,000 level, but you had to be a hell of a market timer to keep the gain because there was no more uplifting excitement until the late summer of 1982. That's right: seven years of dullsville, when the yield on five-year Treasuries was 14%. It helped Croesus pay for his daughter's four years at Yale.

So, today have we fully discounted the worst possible outcome? Is there long-term gain in the crystal ball that will obscure any further near-term pain? Goldman Sachs wise men have studied history and concluded with Seth Klarman of the Baupost Group that "waiting for the bottom has proven over the years to be a deeply flawed" strategy.

"Since the bottom is unknowable without the benefit of hindsight, we feel a great long-term track record is only achieved by incrementally investing when valuations are compelling and by withstanding interim downside," says Goldman's Investment Strategy Group.

Still, the value of the market slid to only 50% of gross domestic product in the early 1970s. Today's ratio of above 60% of GDP suggests there's still more possible downside. Goldman is telling its clients to invest only if they can "withstand the pain of further declines in the equity markets" and "further interim declines of 25%-35% are clearly possible." So, fair warning.

Smart bears aren't buying that the worst is over and we're on the road to recovery. David Levy of Levy Forecasts is still spouting his unique prediction of a "contained depression." He calls it "contained" because of the multitude of programs by the Fed, Treasury, FDIC and now G-20 to avoid the 1930s-style turndown in which the Dow lost 88% of its value between 1929-1932 (despite a massive rally in 1930).

Levy, who just made a sweet fortune buying options on Eurodollar futures, is buying 10-year and 30-year Treasuries. He believes their yields are going down sharply, in the case of the 30-year, from 3.6% to 2%. That would be some killing in bonds if he's right. He's also tempted to go short the S&P 500 index, but recognizes how risky that is when you experience sharp 2%-3% spikes upward on a daily basis.

In the 1940s, 1950s, 1970s and the 1980s, the stock market has at times traded 45% below fair value in serious bear markets. Today, the U.S. market is in some ways above the 45% mark. We could still have a ways to go on the downside--if history repeats. Don't necessarily expect history to repeat itself, but don't be shocked if it does.