Investors see recession, economists are still divided

By Will Rugg, Investment Communications Analyst

Fed steps in with emergency rate cut as markets tumble

Equity investors have cast a clear vote of “no-confidence” in the theory that the rest of the world will pick up the slack as US growth falters, sending stock markets tumbling around the globe for a second consecutive day on Tuesday. However, an emergency 0.75 percentage point interest-rate cut by the US Federal Reserve (Fed) provided some much needed respite just ahead of the opening bell on Wall Street.

As the credit crisis that began last July continues to claim new victims, stock markets around the world are experiencing their worst January in post-World War II history. On Monday the MSCI World Index and many regional indices suffered their largest declines since the September 11th 2001 terrorist attacks amid concerns that the rest of the world would not be immune should the US enter a recession.

This week’s rout began in Sydney, with the commodities-biased and economically sensitive Australian All Ordinaries Index falling for the 11th consecutive day. From there it rippled across the globe. While US markets were closed for Martin Luther King Day, US futures tumbled along with the rest of the world.

Cleary the stock market is pricing in recession, although economists and analysts remain divided, roughly down the middle, on whether the US economy will in fact suffer a recession. Even in the recession camp, thus far most prognosticators are forecasting a mild recession along similar lines to the last two (2001 and 1990), which lasted for just 8 months.

Some good news from valuations?

Stock investors, however, can at least take some comfort in the low level of valuations that prevailed even before stock markets around the globe began their current swoon. Taking the high point of October, when many indices around the globe were posting record highs, the price-to-earnings (PE) ratio of the US benchmark S&P 500 was 17.9.

That compares with a PE of over 45 at its peak into the last recession, and a peak of over 25 in the early 1990s. One may argue that prices and valuations never got to extreme levels during the current cycle, as investors rightly avoided the mistake of over-extrapolating the past earnings growth too far into the future.

What might make this recession different?

For most of the US recessions that have occurred in the post-war period, a rise in interest rates in response to inflationary pressures has been the main catalyst, causing a sharp decline in demand for manufactured goods such as cars, and for houses. Producers then needed to work off their excess inventories and job losses followed.

According to NBER, the official arbiter of US recessions, in the 32 that have occurred since 1854, the duration has averaged 17 months. They have become less frequent since 1945, following the end of the Second World War, and have averaged just 10 months.

That the last two recessions were shorter and less severe than the post-war average may be at least partly the result of the reduced role of manufacturing, which has shrunk as a share of GDP. The innovation of just-in-time supply-chain management has also allowed more efficient inventory control, which should in theory reduce the severity and length of any would-be recession.

Other arguments in favor of a mild recession or no recession are that home construction has

already fallen so dramatically since the housing bubble burst in 2006, that it may have already or may soon be reaching a trough. That would mean most of the potential damage to the economy from the housing slump has already been done.

A weak US dollar will also help boost demand for US exports, by making them cheaper in foreign currency terms, particularly if consumers elsewhere pick up the baton as US consumption falters. Meanwhile, the full impact of the aggressive 1.75 percentage points of easing that the US Federal Reserve has already done, together with the potential for further cuts, should help lessen the drag from housing.

Those arguing that recession will be worse this time than in the two most recent examples generally point to the nationwide decline in house prices, something that hasn't happened on a sustained basis since the Great Depression in the 1930s. These more bearish forecasters would also argue that more defaults are likely as unemployment rises, further weakening the balance sheets of banks and crimping lending. Furthermore, while the housing bubble that followed cushioned the fallout from the bursting of the tech bubble in 2001, there is no obvious candidate for the next bubble to replace housing.

A key question for the rest of the world outside the US is whether the strong growth in domestic consumption in emerging economies, which now make up roughly half of global gross domestic product (GDP) and account for more than half of the growth in GDP, will compensate for weaker US demand. The more pessimistic forecasters would argue that the increased integration of global economies would make it difficult for the rest of the world to weather a recession in the US economy, the world's largest.

This seems to be the conclusion of global equity investors, if this week's plunge in global equities is anything to go by. Over the past six US recessions, the S&P 500 has fallen an average of 4.1% in the six months prior, and a further 5.7% during the recession, before the typical rally that follows. While the most recent example was more severe, with stocks falling before, during and after the recession, this was also preceded by bubble conditions.

S&P 500 returns before, during and after past 6 recessions

Recession	6 Months Prior	During	6 Months After
Dec '69 to Nov '70	-8.9	-11.3	20.5
Nov '73 to Mar '75	1.1	-24.7	6.5
Jan '80 to Jul '80	5.8	5.8	18.8
Jul '81 to Nov '82	-3.8	1.9	23.0
Jul '90 to Mar '91	-0.5	2.5	7.7
Mar '01 to Nov '01	-18.3	-8.1	-6.3
High	5.8	5.8	23
Low	-18.3	-24.7	-6.3
Average	-4.1	-5.7	11.7

Source: Standard & Poors, Wall St Journal

How much further to fall, even if there is a recession?

To be sure, every recession has its own unique characteristics, and these past performances may turn out to have little resemblance to current events. However, by these measures, the S&P 500 may not have much further to fall even if the US economy is entering its next contraction, having already lost 17% of its value from its peak in October to its January 18th close. And for patient investors, taking the average of the last six recessions, US stocks have rallied 11.7% for the next six months after the economy has pulled out of its slump.

About the Author

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Prior to joining SEI, Will previously worked at Invesco Perpetual (Henley on Thames, 2004-2006) in an investment communications role. Will also has worked as a Managing Currency Analyst at Standard & Poor's MMS unit (1998 to 2003). He has a BA in Economics from Colgate University.