

How Bad is this Recession and Bear Market going to get?

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“Financial Advising is a prescriptive activity whose main objective should be to guide investors to make decisions that serve their best interests.” Daniel Kahnemann

Executive Summary

This regular update is intended to be used as talking points with investors.

- While the mainstream community still does not agree we are in Recession, ECRI’s track is unrivalled.
- Bear Markets coincident with recession typically have the worst losses; the median decline during an Economic Bear, since 1899, is 37% implying the S&P 500 would drop to 860 to reach the median.
- Moreover, while the Dow Jones and S&P 500 don’t officially show a 20% loss, other major indices are well into bear market territory and the S&P 500 is likely to catch up.
- Recession is typically not a time to look for a new job, start a new business, or buy a vacation home.

Economic Recessions typically have the Worst Losses

Economic Bears are longer and deeper than Non-Economic Bears. The table below shows a summarized analysis of bear markets in the Dow Jones Industrial average since 1899, courtesy of Leuthold Weeden.

	Median Decline	Median Duration (months)	Worst Decline	Worst Duration (months)
Economic Bear	-36.9%	21.9	-89.2%	36.5
Non-Economic Bear	-27.1%	6.0	-40.1%	41.5

Nearly ¾ of bear markets are linked to an economic recession. Non-Economic Bear markets are often called “Confidence” Bear Markets because they have historically been

associated with some type of confidence crisis. Of the 6 Non-Economic Bears that occurred since WWII, 5 can be explained by an event that significantly decreased confidence: 3 are correlated with entry or imminent entry into wars (WWI, WWII, and Vietnam) and one is correlated with the Soviet Union’s landing on the moon (1966 unmanned – the cold war), one with the Asian crisis (98) and one with the unexplained Flash Crash (87).

While our friends at Leuthold do not yet recognize that the US is going into recession, they nonetheless believe the S&P 500 will likely fall below 1000 before it reaches 1300. We, like them, believed this bear market could have been a Confidence bear market for reasons everyone understands. However we changed our view when ECRI data showed a pronounced, pervasive, and persistent drop in leading indicators consistent only with the onset of Economic Recession. The primary reason for this call is that the Leading Indicator for nonfinancial services, where 5/8 Americans work, has moved downward.

While we cannot know how low markets may drop, should this Economic Bear meet the historical median decline of the Dow, we could expect the S&P 500 to drop to 860. Another research firm we admire, Lombard Street, forecasted a boom in 2011 due to tax incentives (one year reduction in social security tax and one year ability to expense capital equipment). These incentives do not appear to be enough to incentivize businesses to increase spending or consumers to spend (instead of continuing to deleverage their balance sheets). These tax incentives will disappear in 2012. This combined with (necessary) political pressure to reduce spending and populist pressure to increase taxes, a quick recovery does not yet appear on the horizon.

In any case, our decision to take more risk will be validated by an upturn in global industrial growth which typically precedes an economic expansion and market bottoms.

This World is in a Serious Bear Market – the S&P 500 and Dow Will Probably Catch Up

While the S&P 500 and Dow Jones Industrials have still not dropped the requisite 20% many consider to be necessary to be called a bear market, this is misleading because broad global markets have dropped much lower. Below is a quick summary on bear markets lows already reached by other indexes:

- Russell 2000: -29.6%
- NYSE Financial Index: -32.8%
- MSCI EAFE: -27.6%
- S&P 500 High Beta: -40.5%

Within this context, so far this year, the S&P 500 has traded more like a global consumer staples stock than a broad index. We believe the Dow and S&P 500 will catch up and that the risk is to the downside.

Life Implications of Recession.

While the broad public has not yet acknowledged recession, and this recession may prove to be mild should no crisis erupt in Europe or somewhere else, recession is not a time to be taking additional life risk. Some things to avoid typically include:

1. Seeking new employment or asking for a raise
2. Buying a bigger home
3. Expanding a business
4. Any discretionary spending that can be deferred
5. Buying a second home

During recession, prices typically improve and deals will be had toward the end of the recession. Moreover, because the broad public will not understand the expansion signal, when risk is much reduced, prudent actions during recession can be used to benefit your family when the Expansion call is made. Since ECRI's data shows we are likely in a period of more economic volatility, i.e. more frequent and shorter periods of economic contraction and expansion, this behavior may become even more important.

Recession Length and Expansion Call

We would not expect for this recession to end until at least February or March of 2012. By then everyone will know we are in recession. Instead we expect the economy to get "a lot worse from here", according to Lakshman Achuthan. If it is a mild recession, like the recessions of 2001 or 1990-1991, more likely it will last until at least the fall of 2012. But the risk is that there is a negative shock before leading indicators begin to recover. Should this happen, downside risk may be substantially higher. Below is a link to an interview of Lakshman Achuthan, of ECRI, on the possible severity of the recession.

http://www.businesscycle.com/news_events/event_details/1483

The best thing about recessions is that they always end. Fortunately, our ECRI subscription will give us sufficient lead time to take advantage of the upturn. Since 1950, upturns in the ECRI Long Leading Indicator have preceded an upturn in stock prices usually about 8 months (and have not yet turned up). Moreover, we are constantly monitoring the valuation and interest rate environment and seeking information from other unbiased sources to validate our call. When we get the expansion call, we will be in a position to take greater market risk and take advantage of the subsequent upside potential.