globalview
Professional Experience, Unbiased Perspective

The Economy and Stock Performance

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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 clients.

- Deep recessions cause major stock market crashes; while other factors also come into play, the ability to predict major turning points in the economy is invaluable.
- The Economic Cycle Research Institute has a stellar record at predicting changes in the growth rate of the economy that lead to either a growth recession (where growth slows below trend) or an actual recession where growth turns negative.
- Changes in the growth rate cycle (growth rate recession and recession) are highly coincidental with movements in risk asset prices, like stocks.
- ECRI's latest call is for lower global industrial growth. While this does not mean the US economy will necessarily decelerate in the near-term, it means risk asset prices no longer have a clear tailwind.
- When the tech bubble burst, our long-term portfolio managers had steered clear and many of them actually experienced positive returns in 2000, 2001, and 2002, with client returns generally in the negative single digits overall. However, the Great Recession of 2008-2009 caused our Long-Term Portfolio model to lose about 25% in 2008. We have implemented a strategy with the intention to reduce future losses in half and take increased risk in the subsequent and inevitable upturn which follows.

When Recessions Happen, Stock Prices Usually Fall

While bear markets sometimes happen without recessions, serious bear markets often coincide with the beginning of recessions or accelerate during them. After the fact, we know for certain that the economy started turning down in late 2007, then plummetted as the recession accelerated in late 2008, recovering only as the economy began to stop bleeding in March of 2009. After the fact we know for certain that the economy began to recover Spring or Summer of 2009. Right is a table detailing how much the economy fell and the stock market with it during the five worst recessions since 1929:

Recession Period	Duration (Months)	Decline in Real GDP	Drop in S&P 500
1929-32	43	30.0%	-86.0%
1937-38	13	18.2%	-49.1%
1973-75	16	4.9%	-48.0%
1981-82	16	3.0%	-26.0%
2007-09	18	3.8%	-55.0%

Not all market crashes are associated with a recession. Of the eleven worst market crashes in US history, six were during periods of political distress leading to war. When these do occur, nearly all risk asset prices fall in value, however, unless the economy dips into recession they generally bounce back quickly. Clearly the greatest declines have been associated with deep recession or depression or small drops have become much worse with the recognition of recession.

The problem is, we generally don't know when recessions start or end until well after the fact. Investors, Advisors, and other pundits calling for a Double Dip Recession last summer and Fall frankly didn't understand history very well. The last double dip recession was as an intended result of government policy. With global governments highly stimulative, there were very low odds of a double dip. The question is, is there anything we CAN observe that will help us determine when a recession is again likely?

Predictive Value of Changes in the Economic Growth Rate Cycle

Leading Economists, Pundits and the National Bureau of Economic Research (NBER – the offical agency dating recessions in the US) have done practially nothing to forewarn us of coming recessions with one notable exception. The Economic Cycle Research Institute (ECRI) has correctly called increases and decreases in the economic growth rate cycle over the last decade. These calls are closely coincident with increases and decreases in risk asset prices (see our Q1 2011 newsletter); we have this documented. In October of last year, ECRI informed us that the US would not face a double dip recession, and forecasted an increase in the rate of economic growth shortly thereafter. In November the S&P 500 traded at 1181 and subsequently rose to 1340 before they began warning of a possible slowdown.

ECRI's latest call is a slowdown in global industrial activity beginning this summer, i.e. July or August. While this is not yet a call for an *overall* economic slowdown (industry is about 20% of the US economy), it means, to use a cycling analogy, that we are no longer riding with a tailwind. While the headwind has not yet appeared it has become more likely. When ECRI calls a growth deceleration in other leading indexes like the Leading Services and Leading Construction indexes, this will be and even more clear signal to take risk off.

Recessions are generally caused by a combination of enogenous cyclical forces and external shocks. Recessions quite often occur when oil prices rise and interest rates are high. However, until now, the endogenous cyclical forces have been sufficient to ward off high oil prices. This is no longer necessarily the case, meaning we need to become more vigilant.

Risk- Based Asset Allocation – Global View Long-Term Portfolio

We have been managing clients weatlh since early 2000 and have been through two major bear markets. During the first, in 2000, our clients using managers in our Long-Term portfolio suffered only single digit losses at any given time due to their broad diversification across market capitalizations and geography. Our model Long-Term Portfolio lost about 25% in 2008, only 2/3 of the S&P 500. Our Retirement Spending Portfolio lost about 12%, generally less than corporate bonds. Nearly all of our clients stuck to their strategy. We consider this a major win. That said, we are NOT complacent to allow this type of loss occur again.

In fact, we have modified our Long-Term Portfolio strategy to take advantage of these changes as follows.

- When we fear a recession is imminent, we will reallocate the portfolio to 50% volatiliy control investments (and may take a small short position), that we believe will capture very little downside of the broad market and reallocate the remaining 50% into Long-Term Less Volatile investments.
- When prompted by either favorable valuations or a trend change in the economy to positive growth, we will reallocate the Long-Term portfolio into 50% Long-Term More volatile investments, which we believe will capture over 100% of the upside of the S&P 500.
- When we believe an economic slowdown is imminent, but a recession is not yet preordained, we will allocate 25% to Volatility Control investments, 50% to Long-Term Less Volatile investments, and 25% to Long-Term More Volatile investments.

Currently we are, perhaps prematurely, allocated about 25% in volatility control, 50% Long-Term Less Volatile, and 25% Long-Term More Volatile and will likely moderately underperform should the global rally continue in 2011.

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