Philequity Corner (January 14, 2008)
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The "R" Word

Everyone is talking about it. But most people, especially the Americans, are afraid to even mention it. They call it the "R" word, short for recession. So, is the US economy already in a recession? Or if not, is it close to one? What happens to the stock market? What does it mean to investors?

Reality check

Last week, Merrill Lynch became the first major bank to declare that a recession in the US is now a reality. According to their report, the four key barometers used by the NBER (mentioned in the previous paragraph) seem to have peaked around the November to December period and that a recession is well underway this month.

Another Wall Street heavyweight, Goldman Sachs, concurred with Merrill's pronouncement. In a note to clients, Goldman said that the US economy would contract by 1 percent on an annualized basis in both the 2nd and 3rd quarters of 2008. For the whole of 2008, however, the investment bank said GDP would rise by 0.8 percent. Goldman sees the Fed lowering rates aggressively from the current 4.25 percent down to 2.5 percent by late-2008.

Market performance during recessions

If there indeed is a recession, it will be the 12th recession since the Great Depression of the '30s ended. Fortunately, though, the average recession post-Depression has lasted only ten months from the peak of activity when the recession began to the eventual trough when the recession ended and the economy turned up. Even the longest of the downturns only lasted 16 months while the shortest was over in just six months.

Assuming a worst case scenario of a recession this year, what does it mean for stocks? The table below shows the past recessions since 1929, their duration, and the corresponding performances of the Dow Jones Industrial Average (DJIA) during the different recession periods.

Recession Peak	Trough	No. of months Contraction	% Chg of DJIA Peak to trough
August 1929 (III)	March 1933 (I)	43	-85.4%
May 1937 (II)	June 1938 (II)	13	-23.4%
February 1945 (I)	October 1945 (IV)	8	16.3%
November 1948 (IV)	October 1949 (IV)	11	10.7%
July 1953 (III)	May 1954 (II)	10	18.9%
August 1957 (III)	April 1958 (II)	8	-5.9%
April 1960 (II)	February 1961 (I)	10	10.0%
December 1969 (IV)	November 1970 (IV)	11	-0.8%
November 1973 (IV)	March 1975 (I)	16	-6.6%
January 1980 (I)	July 1980 (III)	6	6.8%
July 1981 (III)	November 1982 (IV)	16	9.1%
July 1990 (III)	March 1991 (I)	8	0.3%
March 2001 (I)	November 2001 (IV)	8	-0.3%
Average (post-'30s Depression)		10	5.3%

Source: NBER, Wealth Securities Research

Since our scenario calls for a recession and not a depression, we removed the 1929-1933 and 1937-1938 periods in our computation. On the average (post-'30s Depression), the DJIA gained 5.3 percent during these recessions. At worst, the DJIA was down 6.6 percent (1973-1975). At best, the DJIA was up 18.9 percent (1953-1954) Therefore, while the DJIA may have experienced wild swings and sharp declines within these periods of contraction, the index ended these instances with a significant gain most of the time.

Note that when the most recent recession ended in November 2001, the stock market took another downturn because the US waged war against Afghanistan and Iraq – not because the ill-effects of the economic slowdown took longer to dissipate.

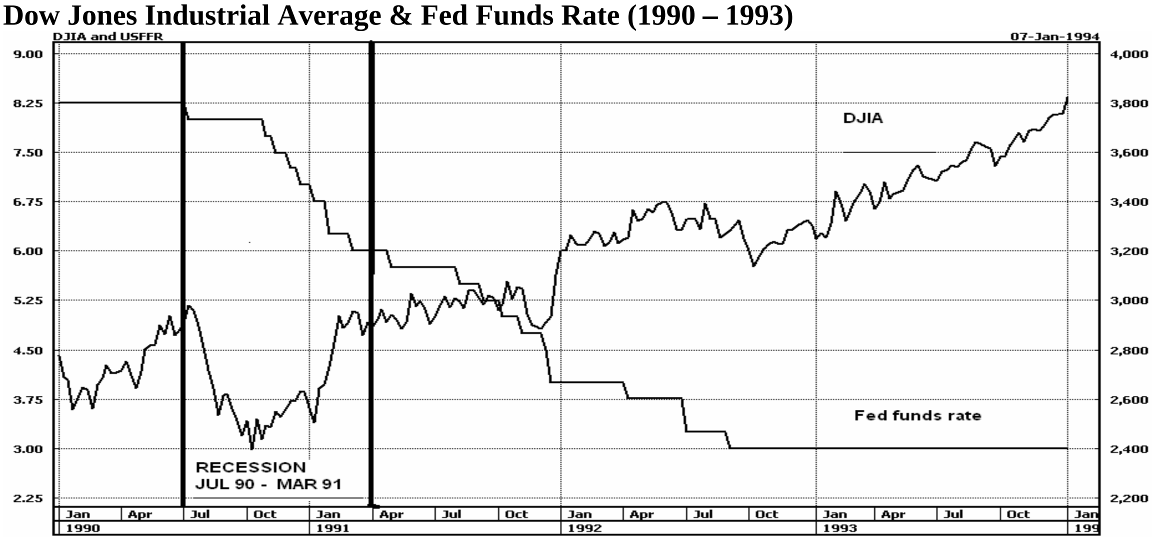
1990s S&L crisis
History does not repeat itself, but it does rhyme. Therefore, it is always helpful to identify periods with similar patterns to help gauge the odds of possible scenarios in today's markets.

There are currently a number of similarities to the global economic and financial environment during the 1990s and today. In 1990, the US was entering a recession caused by previous Fed tightening and a real estate market crisis (savings & loans). There was also a spike in oil prices due to Iraq's invasion of Kuwait, further dampening growth.

Moreover, in the 1990 sell-off, stocks were down 20 percent with bank stock prices collapsing by 40 percent, similar to today. Emerging market stocks, which were also experiencing a bull market back then, plunged by over 30 percent in US dollar terms. However, this proved to be a bull market correction for emerging market stocks.

The Fed aggressively cut rates from 8.25 percent to 3 percent in a span of two years. Stocks were well on their way to recovery after the 2nd cut. And even before the recession was over, the DJIA was back to its previous level prior to the recession.

Dow Jones Industrial Average & Fed Funds Rate (1990 – 1993)



Source: Technistock

Recovering from a recession
How fast the economy and the stock market recovers (this time around) depend on how fast the Fed aggressively cuts rates. Another factor is how aggressively the banks will clean their books and dispose their holdings of sub-prime debt and CDOs.

Already the Fed is preparing for the worst. In a speech last week, Fed Chairman Ben Bernanke gave the clearest indication yet that it will move aggressively to cut interest rates to try to prevent a serious economic downturn. He said that in light of recent negative economic news, "additional policy easing may well be necessary." He further added that the central bank is "ready to take substantive additional action as needed to support growth and to provide adequate insurance against downside risks." Given the tools at its disposal, odds are high that the Fed will able to minimize the downturn, in case there will be. Note that the two most recent recessions lasted only eight months each.

Aside from Fed cuts, the US government is also considering a number of fiscal stimulus measures (such as tax rebates) to revive its flagging economy. Former US Treasury Secretary Lawrence Summers urged a stimulus of as much as $75 billion, while presidential candidate Hillary Clinton unveiled a $70 billion stimulus plan.

Strategy during recession

In this article we assumed the worst case scenario that the US is indeed headed for a recession. We showed how stocks performed during these periods, especially during the 1990s where the situation is most similar to where we are now. Investors could then use this as basis for trading this market and for timing purchases for the market's next leg.

If Merrill is correct that the economy is already in a recession starting this month, or if Goldman's prediction of a mild recession in the 2nd and 3rd quarters comes true, then by end-2008 the US economy may already be well into recovery. And if history would be our guide (barring the appearance of Nassim Taleb's black swans), chances are that stock prices would be higher by then.

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