

INSIGHTS ON FRONT STREET



BY JASON P. TANK, CFA

IF IT WALKS LIKE A DUCK...

SEPTEMBER 2008

The big question for investors today shouldn't be about whether we're in a recession or not, but rather how long and how deep this recession will be. That isn't to say that the official authorities have even declared a recession yet. That doesn't really matter to us. The official word usually follows within a year after the recession's start. By that point, it's way too late to avoid losses. What has our attention isn't 'if' one has started and our thoughts aren't even about 'when' one may have started. Instead, turning to the last page of the book and reading it in reverse is a logical way to figure out what to do today.

Since 1960 the US has experienced seven recessions and our economy lived through them all. So, we are optimistic about our economy over the long term.

That doesn't mean that investors haven't felt pain during them and how investors react to a recession is very important. Getting the timing right isn't easy, but there are signals that can be read along the way to guide you to the right decisions.

Here is a quick history of the anatomy of recessions in the US. From this we can gain a little more insight into the general damage that can be inflicted on investors and how things play out *on average*:

April '60 - February '61

Its length was 10 months and the stock market bottomed about 3 months before its official end. Unemployment went from 5% to 7%. The market fell about 17% from its peak.

December '69 - November '70

Its length was 11 months and the stock market began its recovery about 6 months before its official end. Unemployment went from 3.5% to 6%. The market dropped about 35% from its peak.

November '73 - March '75

Its length was a little longer at 16 months and again the stock market bottomed 6 months before this recession's end. Unemployment went from around 5% to 9%. The market fell about 45% from its peak. By the way, this was a really bad market experience for many and prompted a good number of professionals to quit the investment business altogether.

January '80 - July '80

Its length was a short 6 months and the stock market bottomed out about 3 months before the end. Unemployment went from about 6% to almost 8%. This time the market fell 15% from its recent high. This recession came on after years of sideways and dismal stock market action. So, it felt a little like kicking a dead horse. And, at this point, stocks were dirt cheap and nobody wanted to own any.

July '81 - November '82

Its length was 16 months (it was the second dip of the "double-dip" recession) and the stock market, once again, bottomed about 6 months before its official end. Unemployment exploded from a bad 8% to a worse 11%. This time the market fell about 24% from its peak.

July '90 - March '91

This recession's length was a short 8 months and the stock market bottomed, yet again, about 6 months before its official end. Unemployment went from about 5% to 7%. This time the market fell about 21% from its high.

March '01 - November '01

This recession's length was also a short 8 months and the stock market bottomed only 2 months before its official end. Unemployment rose from about 4% to nearly 6%. This time the market fell about 33% from its high.

So, there you have it, seven recessions since 1960 with the following average statistics:

- they lasted an average of 11 months.
- unemployment usually rises about 2% to 2.5%.
- stocks bottomed 4 to 5 months from the end.
- stocks on average drop was 27% from the peak.

Where do things stand today?

So far we know that the last quarter of 2007 the economy showed negative growth and for the first quarter of 2008 it posted a barely positive figure. That quarter could eventually be revised into negative territory in the future. The negative number in late 2007 points to the possibility that an official recession may have started just before 2008 began.

However, the economy in the second quarter of 2008 recently posted a big positive growth figure due mainly to the effect of the stimulus checks and a big shift in imports and exports. Our best guess is that, if we did enter a recession in late 2007, we probably *technically* took a short-term breather and will be entering a second recessionary dip reminiscent of the double-dip in the early '80s.

First, while import activity is slowing (domestic demand usually drops during a recession), exports are also likely to slow down as the rest of the globe is already showing signs of slowing down. For this reason, we probably won't be exporting our way to prosperity in the coming quarters. And, the export driven Asian economies probably won't be growing as fast with a slowing US economy. Second, our politicians aren't going to be sending another round of stimulus checks until possibly early 2009. It just isn't in the political cards because the timing is all off.

Turning to the unemployment picture, it bottomed at 4.3% in early 2007 and now has risen 1.4% to

reach 5.7%. This is not yet quite as much as the typical spike in the unemployment rate as seen during previous recessions. Our best guess is that we'll likely see unemployment continue to move up to the mid 6% or possibly reach 7% before this is all done. Our concern is that further job losses will exacerbate the housing mess and through that, hurt banks further which would likely result in more credit tightening all around.

The stock market reached yet another "bottom" in mid-July after the financial sector took a massive dive in May and June. Since that time, there has been some recovery, mainly in those same financials and consumer-spending stocks, but it hasn't amounted to much movement overall.

We don't have a strong opinion on commodities (oil, metals, etc.) but we do believe that their sudden price drop is telling us that overall global demand, including US demand, is falling off and will likely continue to fall for a while longer. It is a classic stage, really.

We do want to state that nobody *knows* the actual path our economy will take in the coming months. We are simply doing our best to thoughtfully evaluate the picture and to try to best prepare portfolios for the range of likely outcomes that could happen.

If we are right about the economy deepening its descent, and that company earnings will come to disappoint investors, then our historical review of previous recessions shows that the stock market will begin to recover about 3 to 6 months before the economy turns positive again. However, until you know when the end is reached, this little factoid doesn't help too much!

Our belief is that our economy has been struck a severe blow to one of its most important drivers, the availability of credit. Because of the damage this inflicts, we expect this recession to drag on longer than most investors believe. Our most likely guess is that the recession ends around mid-to-late 2009. Remember, on average, stocks go down about 30% from their pre-recession peak and, as of today, we've now only seen half the trip to the bottom. Loss avoidance rules our thoughts right now and we believe our portfolios are rightfully positioned accordingly.



FRONT STREET
INVESTMENT MANAGEMENT