

Has the US stock market already discounted a recession?

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Right now, investors with a long-term perspective may be wise to consider not whether the US economy is in – or is poised to enter – a recession, but to what extent the stock market is already discounting economic weakness.

As of 22 January 2008, the US stock market has declined more than 15% from its October 2007 peak. This is similar to previous recession-related declines in 1980 and 1990. More volatility may be on the way, but Federal Reserve interest rate cuts and widespread recognition of the slowdown may indicate the stock market is closer to a “bottom” than a “top.”

PREVIOUS US RECESSIONS

Economic recessions generally take a while to officially diagnose, on average being announced six months after the recession already began. They generally coincide with stock market downturns: the last four US recessions coincided with market corrections of between 17% and 49%.

Because economic data lags whilst stock markets look forward, sometimes much of stock market declines have occurred before a recession is officially announced.

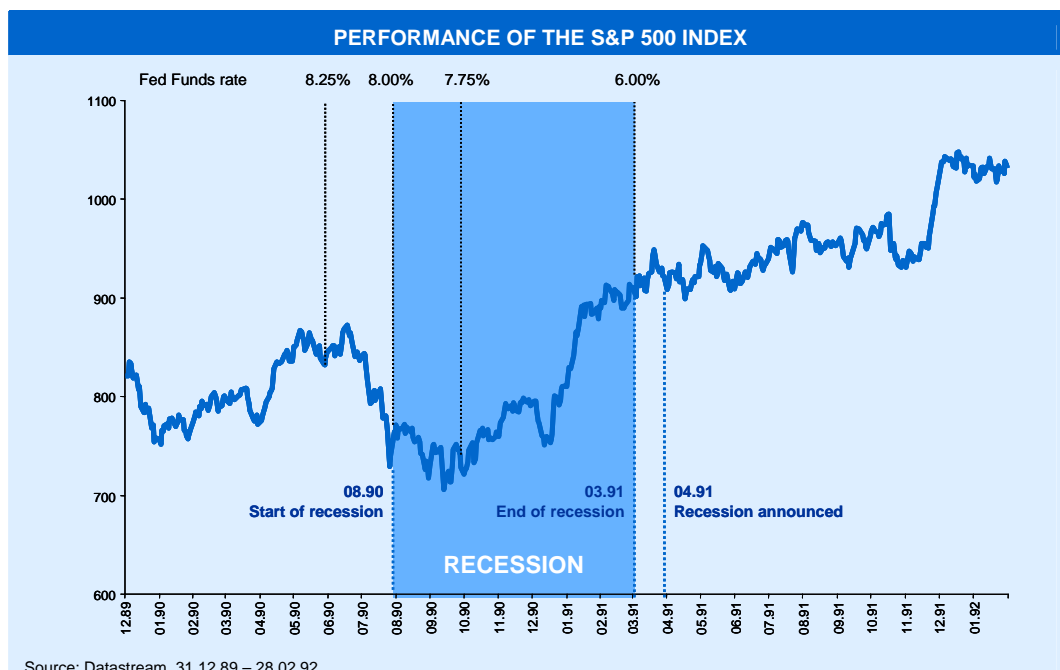
Recession start date	Announcement of recession	Number of months in recession prior to announcement	Stock market decline prior to recession announcement	Total stock market decline (peak to trough)	Stock market performance after recession trough / announcement	Fed monetary policy action prior to start of recession	Stock valuation prior to start of recession
Two recessions when the stock market fully discounted recession prior to the announcement that the US economy was, indeed, in recession							
February 1980	June 1980	4	-17%	-17%	39%	Hiking	Below average
August 1990	April 1991	9	-20%	-20%	27%	Easing	Average
AVERAGE			-19%	-19%	33%		
Two recessions when the stock market continued to decline after the announcement that the US economy was in recession							
August 1981	January 1982	5	-13%	-27%	15%	Hiking	Below average
April 2001	November 2001	7	-14%	-49%	-8%	Easing	Above average
AVERAGE			-16%	-38%	4%		
2007?	2008?	?	-15% (so far)	-15% (so far)	?	Easing	Average

- 1980** Entire market decline occurred prior to the official announcement of recession
- 1982** The stock market corrected even after the announcement of a recession, which was particularly painful because prior to the start of the recession the Fed had increased interest rates to 14%.
- 1990** The circumstances surrounding this recession might be the most similar to today: a real-estate induced economic downturn; banking system spillover; Fed already easing; and average stock valuations.
- 2001** The stock market continued falling after the recession announcement due to lofty stock valuations and the bursting of tech sector bubble.

A CLOSER LOOK AT 1990

1990 might be the most similar to today, with a real estate-induced economic downturn, banking system spillover, the Fed already easing, and average stock valuations.

The US economy slowed in the face of a weakening housing market exacerbated by real estate lending excesses. Where it was the savings & loan crisis in 1990, it is the sub-prime mortgage crisis today. Massive losses (and bankruptcies of S&Ls) among financial institutions threatened the banking system and resulted in tighter credit conditions for businesses and consumers. The Fed began rate-cut cycles prior to the beginning of that recession, lowering the Federal Funds rate from 8.25% to 3% (1990-92). Likewise, today we see the Fed taking similar actions, cutting from 5.25% to 3.5% (Sep 2007 – Jan 2008). Both in 1990 and today, valuations were/are near historical averages. At 15.2x at the beginning of the 1990 recession, the price-to-earnings (P/E) valuation for stocks was a bit below its historical average of 17.4, compared to slightly above 18.7x today.



CONCLUSION

Markets have been particularly weak in the first few weeks of 2008. The circumstances behind the current volatility might be unique, but investors' reactions to them have many parallels to those witnessed in the past. Even as the US economic picture remains uncertain, there are still companies with good balance sheets, strong management and successful businesses. 2008 may therefore offer attractive opportunities in some of the companies whose share prices have been most adversely affected to date.

One of the most common mistakes many investors make when they invest in stock markets is to buy when times are good and markets are high only to be shaken out in uncertain times when markets are lower. Investors should be prepared to ride out these fluctuations and take a longer term view. Sometimes the noise in the market can cloud out what's really going on. Today's volatility comes at the end of a bull run for world stock markets that has lasted much longer than the average. There is no reason to suggest that another bull run won't follow at some point.

Note:

All recession dates are from National Economic Bureau of Research, Haver Analytics.

Stock market returns are represented by S&P 500 Index (Source: FactSet).

Total stock market decline measures cycle peak to trough of period that coincides with an economic recession.

Fed action prior to recession indicates the most recent action taken by the Federal Reserve prior to the recession start date.

The stock market valuation is measured by the price-to-earnings (P/E) ratio of the S&P 500 Index, using 17.4 as the long-term historical average. The valuations immediately prior to the start of recessions were as follows: 7.5 (1980), 15.2 (1990), 8.6 (1981) and 25.5 (2001) (Source: FactSet, Haver Analytics).

For recessions when entire correction occurred prior to the recession announcement, the recession trough was used as the starting point. For recessions when the correction continued past the recession announcement, the announcement date was the starting point.

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