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Are Markets Signaling Another Recession?

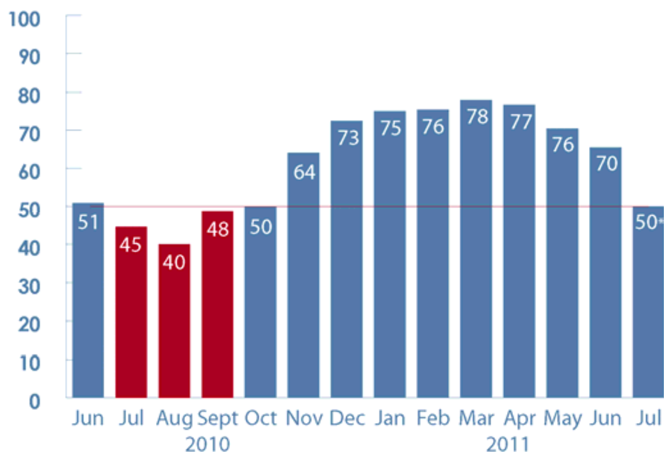
Financial markets have been hit hard by a mix of slower growth, a rating cut for U.S. Treasury bonds, and fear that Europe's debt crisis may deepen. Stocks have fallen sharply, and government bonds have risen. Gold recently touched $1,900 an ounce. The mood is very poor. Markets have moved much closer to the "fear" end of the "fear-greed" spectrum.

While a recession would mean lower stock prices, a longer view reminds us that tough times also create opportunity. Stock holdings should be viewed as part of an overall mix of personal assets. A balanced approach allows for smart risk-taking.

Recession or Slow Growth?

A recession or financial disruption would likely mean that the rough ride in stocks is not over.

Economists are cutting growth forecasts, as most recent indicators point toward slower growth. About half the data we monitor is trending toward recession. Our fundamental conditions index has dropped to 50 from 80 earlier this year (see chart below). Bonds are rallying, and stocks are falling. Interest rates remain near 0%. Government spending is likely to be cut next year. Taxes are set to rise. Weaker economic data, low-risk investor mentality, and waning stimulus dollars raises the odds of another recession. At this time, we put the odds of a recession near 40% — not a foregone conclusion.



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A 10 to 50% stock market decline has been normal during recessions since the 1960s. The average market decline during past recessions is about 30%, but declines vary based on a number of factors. The depth and length of the downturn, government policy, the health of banks, and debt levels are all important factors. The degree to which the downturn is anticipated is also important.

Since April, the S&P 500 index of large companies is down 16%. Long-term U.S. Treasury bonds, Intermediate-term U.S. Treasury bonds, and high-grade corporate bonds have returned 19%, 11%, and 3%, respectively. Gold has risen 17%. A balanced approach that combined all of these assets performed better than an all-stock portfolio during this period. Balance and consistency are valuable when the economy weakens.

What If?

A second recession, following so closely on the heels of the last one, would be a major setback. It would be the first time since the 1930s that the economy failed to restore the private sector jobs lost during the downturn. A second recession would hit when interest rates are already at 0%, and government finances are already strained (a fact underscored by Standard & Poor's recent downgrade of U.S. debt). In a recession scenario, stocks would likely lose additional ground to bonds as earnings fade. Bonds would likely retain their role as preferential, safe-harbor assets and a hedge against bad news.

Our indicators still are pointing toward slow growth at this time. Further slippage might make the case for an even more defensive portfolio. For now, we continue to stress balance and consistency over risk and growth in portfolios.

Bernanke's Next Move

Ben Bernanke will take the podium in Jackson Hole this Friday. His speech is expected to address steps the Fed might take to help the economy in light of recent news. At last year's speech, Chairman Bernanke announced $600 billion of asset purchases to help prevent deflation.

This time, another round of asset purchases may be a more difficult sell. Inflation is higher now than last year, and more board members are expressing concern about future inflation. What can the Fed do to stimulate growth now that interest rates are at 0%? They could do several things:

For example:

- Increase the Fed's target range for inflation to create a sense that the Fed is serious about preventing deflation;
- Reduce the rate of interest paid to banks on $1.7 trillion of excess reserves to incentivize banks to make loans and investments rather than sit on idle reserves;
- Choose to hold more long-term Treasury bonds over short-term bonds to drive down longer-term interest rates;

- Remind investors of previously offered programs that were designed specifically to guard against significant market disruptions;
- Discuss the potential for additional asset purchases, if necessary.

Bear Markets Create Opportunities

We believe the market will find a bottom in time, as bad news is eventually fully reflected in prices. Some combination of improving news, policy action, or investor capitulation typically brings market declines to an end. We note that, although bad news continues, markets seem to be pricing much of it in already.

One way to measure this "pricing in" is to compare the yield on stocks to the yield on bonds. The S&P 500 currently "earns" around $95. The index trades near 1160. Dividing the $95 in earnings by the index gives us an "earnings yield" of about 8%. U.S. Treasury bonds offer investors a yield of just over 2%. The 6% difference is significant and suggests that investors are fairly pessimistic in their outlook for the economy and profits. Even if earnings were to be cut to $70 or $80 for the S&P 500 one could argue that, compared to bonds, stocks are attractive.

Conclusion

A recession would be an unwelcome event. We still see modest growth, but the risk of a recession is clearly higher. Especially until we see some improvement, smart decision-making can be helped by keeping balance. Balance allows for smart risk-taking because it prevents emotions from driving decisions to buy and sell. Since bad news may be with us for a while longer, an emphasis on balance, consistency, and quality is the right strategy for volatile markets.

Index Definitions

Barclays U.S. Government Inflation-Linked Bond Index measures the performance of the U.S. Treasury Inflation-Protected Securities ("TIPS") market. Used as a proxy for "inflation-protected bonds."

Bloomberg/EFFAS Bond Indices U.S. Government 1-3 Year Total Return Index is a transparent benchmark for government bond markets. Indices are grouped by country and maturity sectors. Bloomberg computes daily returns and index characteristics for each sector. Used as a proxy for "short-term Treasuries."

Bloomberg/EFFAS Bond U.S. Government 10+Year Total Return Index is a transparent benchmark for the total return of the 10+ year U.S. Government bond market. Used as a proxy for "long-term Treasuries."

FINRA-Bloomberg Active Investment Grade U.S. Corporate Bond Index and FINRA-Bloomberg Active High Yield U.S. Corporate Bond Index are comprised of the most frequently traded investment-grade and high yield U.S. corporate fixed coupon bonds represented by the Financial Industry Regulatory Authority (FINRA) transaction reporting facility. Used as proxy for "high-yield bonds."

FTSE NAREIT Equity REIT Total Return Index is a total return performance index of all equity REITs tracked by NARIET. Used as a proxy for REITs.

MSCI EAFE International Index is a free float-adjusted market capitalization index that is designed to measure the equity market performance of developed markets excluding the U.S. and Canada. As of June 2007, the MSCI EAFE Index consisted of 21 developed market country indices. Used as a proxy for "developed foreign."

MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. Used as a proxy for "emerging markets."

Russell 1000 Index measures the performance of the 1,000 largest companies in the Russell 3000 index. The Russell 3000 Index measures the performance of the 3,000 largest US Companies based on total market capitalization, which represents approximately 98% of the investable U.S. equity market. Used as proxy for domestic "large cap stocks."

Russell 2000 Index measures the performance of the 2,000 smallest companies in the broader Russell 3000 index. Used as proxy for "small cap domestic stocks."

Russell 3000 Growth Index measures the performance of those Russell 3000 Index companies with higher price-to-book ratios and higher forecasted growth values. Used as proxy for "domestic growth stocks."

Russell 3000 Value Index measures the performance of those Russell 3000 Index companies with lower price-to-book ratios. Used as proxy for "domestic value stocks."

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Asset allocation and diversification do not ensure a profit and may not protect against loss. There are special considerations associated with international investing, including the risk of currency fluctuations and political and economic events. Investing in emerging markets may involve greater risk and volatility than investing in more developed countries. Due to their narrow focus, sector-based investments typically exhibit greater volatility. Small company stocks are typically more volatile and carry additional risks, since smaller companies generally are not as well established as larger companies. Property values can fall due to environmental, economic, or other reasons, and changes in interest rates can negatively impact the performance of real estate companies. When investing in bonds, it is important to note that as interest rates rise, bond prices will fall. High-yield bonds have greater credit risk than higher quality bonds. The risk of loss in trading commodities and futures can be substantial. You should therefore carefully consider whether such trading is suitable for you in light of your financial condition. The high degree of leverage that is often obtainable in commodity trading can work against you as well as for you. The use of leverage can lead to large losses as well as gains.