



*Tocqueville Asset Management L.P.*

## **THE ECONOMIC ALPHABET GAME**

### **Which Path Will The Economy Follow Beyond The Current Recession?**

With the recession now almost fourteen months old and giving few signs of abating, an alphabet game has started among economists trying to fathom where we go from here: will the recession and the subsequent recovery look like an L, a V, a U or a W?

#### **The “D” word, but with a “d”**

A growing number of seers have even been uttering the “D” word: *Depression*. But the problem with the “D” word is that there is no precise definition of an economic depression, so that the word almost immediately conjures memories of the *Great Depression*, which ravaged the world economy in the 1930s.

When the “entertainers” on the leading TV business channels began throwing the word around, I retrieved an old book, written in 1902 by Theodore E. Burton: *Financial Crises and Periods of Industrial and Commercial Depression*. The book has much historical interest, but its main quality is that it was written *before* the Great Depression forever changed the meaning and implications of the “D” word.

Let me quote: “A period of depression may be briefly defined as a protracted season in which the activities and profits of industry and trade fall materially below their normal level... In distinction to a *panic* or *crisis*, it refers to a prolonged period. It is not a matter of days, but of years.”

Thus a depression is not necessarily the once-in-a-lifetime, extraordinary event implied by the experience of the 1930s, but a somewhat deeper and more-stubborn-than-normal recession, of which there have been repeated examples in history.

#### **Reconciling the time horizons**

The challenge today (as perhaps in past episodes) is to reconcile the implications of recent events over two different time horizons.

Over the shorter horizon of a typical economic and financial cycle (a couple of years), many variables already have corrected in line with past experiences. It could be implied that they are not far from recovering.

Over the longer horizon of several years, however, it is clear that excesses and imbalances in the economic and financial arenas that took two decades or more to build cannot be erased and corrected in eighteen months. Until they are, however, obstacles to a faster and more sustainable pattern of economic growth will remain.

A few times over the past year, (for example, in [“Phew”, you said?](#) - 5/21/08), I made the point that, to reconcile the cyclical and secular implications of the present economic and financial situation, “*we may need a second recession and bear market in a few years.*”

### **Introducing the “W”**

Now, the idea of a W-shaped recession is gaining ground. This is why it is timely to revisit two economists who clearly saw the current recession coming and also warned of the looming financial problems when a majority still felt that all was well in the best of all worlds. It could be argued that both initially underestimated the depth of the recession and the feedback effects of the financial crisis on the “real” economy but, except for some perennial prophets of doom, they were as close as any to what came to be.

David Rosenberg, at Merrill Lynch, recently stated in a paper that “We are likely enduring a depression today” (Some Inconvenient Truths – 1/26/09). Fortunately, he did not capitalize the “D” word, nor did he draw sensational analogies with the Great Depression. In fact, he went to some length to explain that depressions, in his book, are basically long recessions and that they can last from three to seven years, an echo of Burton’s definition cited earlier. They also “tend to follow years of leveraged prosperity of Gatsby-like proportions”, such as the ones we enjoyed until recently. Rosenberg adds that “depressions often are marked by balance sheet compression and deleveraging: debt elimination, asset liquidation and rising saving rates”. And he concludes: “... it is clear that whatever the solution, it will take time and a shared burden by lenders, households and future generations of taxpayers before we hit bottom in this credit contraction.”

Even more recently, Rosenberg reminded us that, while he anticipates that it will take 15 quarters to achieve the previous peak in real GDP and he now sees a deeper contraction in the first half, he also expects a second half improvement. Appropriately, his paper is entitled “Welcome to the W” (2/6/09).

### **The Great Depression dissected**

Northern Trust’s Paul Kasriel, in “The Great Depression – Just the Facts, Ma’am” (2/9/09) reminds us that “the Great Depression of the 1930s was *not* a decade-long era of economic decline. Rather, it was made up of two *distinct* economic slumps – August 1929 through March 1933 and May 1937 through June 1938”, with the first recessionary period not only longer in duration, but more severe in magnitude.

To illustrate the natural resilience of the *private* economy, Kasriel also points out that in the four years between these two recessions (1933-1937), real GDP *excluding* Federal Government spending recovered at a compound annual rate of 9.4%, while industrial production grew at a compound annual rate of 12.9% and unemployment rate fell from a cycle high of 25.6% in May 1933 to a cycle low of 11.0% in 1937.

Kasriel also makes a point of reminding us that: “Despite protective tariffs, Fed discount rate increases, personal income tax rate increases and massive bank failures [during 1930-1932], the first recession of the Great Depression ended in March 1933, the same month in which Franklin

D. Roosevelt was inaugurated as president. “*That is, the business cycle trough occurred before the “New Deal” policies were implemented.*”

### **Action now, reaction later**

Coming back to the present situation, Paul Kasriel advises us to “never underestimate the *initial* positive impact on aggregate demand of that powerful combination of increased government spending/tax cuts *and* a central bank running the monetary printing press at a high speed”. In an earlier paper (DUBYA – 01/20/2009), he had explained: “The implication of the banking system and the Federal Reserve monetizing large portions of non-financial sector borrowing – government or private sector – is that the borrowers are able to increase their spending without any other entity cutting back on its spending. Thus, in terms of the GDP accounts, total spending in the economy increases. This is why we expect a recovery in real GDP by the fourth quarter of this year.”

Of course, as Kasriel says: “If monetizing non-financial debt were costless, the Zimbabwean economy would be the envy of the world”. Instead, last I heard, this economy is suffering an inflation rate of 231,000,000 % per year (worse than the Weimar Republic) and an *employment* rate of only 6%!

It is therefore logical to expect the Federal Reserve to start cautiously slowing credit creation in the first half of 2010, and to follow with more aggressive hikes in the Federal Funds rate in the second half of 2010, as inflationary pressures begin to intensify. This should trigger the next economic slowdown.

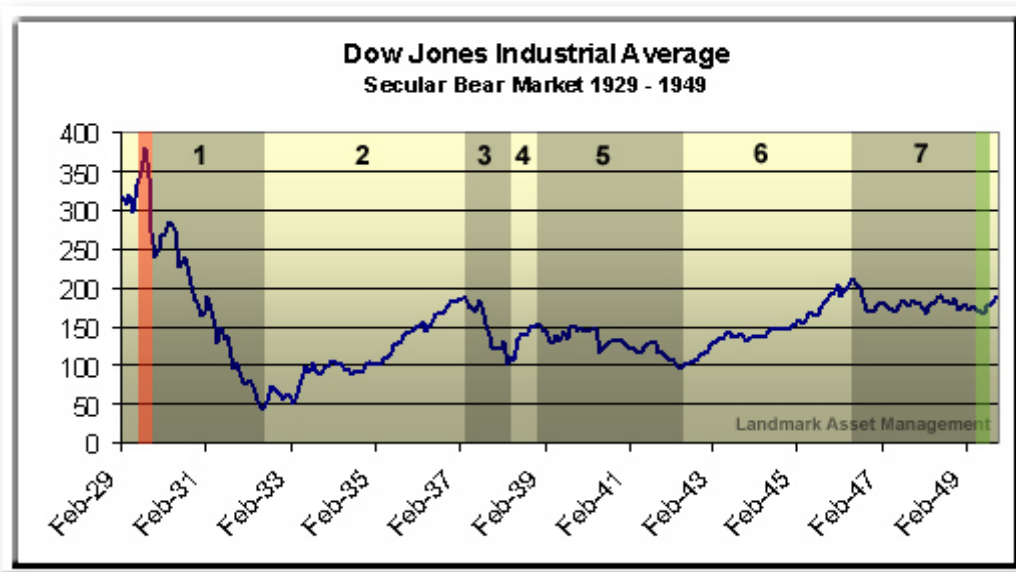
Hence Kasriel’s “W” economic scenario: a late-2009 recovery, followed by a subsequent downturn – or at least a growth recession -- in 2011 or 2012.

### **The second half of the “W” does not necessarily take the market lower**

I would be remiss if I did not illustrate the change in stock market mood which occurred between the two recessions that made up the Great Depression.

As can be seen in the graph below, between June 1932 and February 1937, the Dow Jones Industrial Average rose almost 335%, from 43 to 187.

Of course, this was still more than 50% below the pre-depression stock market high of August 1929, but the second recession low, in March 1938, never even approached the level of June 1932. *In fact, the Dow Jones never again fell to a level lower than double its 1932 low.*



Source: Chart Research

The economic scenarios outlined by Kasriel and Rosenberg are not all roses, of course. Rosenberg, in particular, remains more pessimistic about the near term. But both scenarios would allow long-term financial excesses and imbalances to be largely corrected (or at least on the way to mending themselves) while the cyclical economy goes through the ups and downs of its “W”.

### What does the “W” economic scenario mean for the stock market?

The Dow Jones Industrial Average experienced a 47% decline in 1937-1938, associated with the second recession of the Great Depression. But, after a 335% previous recovery, this only brought the stock market down to a level that was still 50% higher than at the 1932 low. So, waiting for the economic skies to clear up obviously involves some opportunity risk.

I pointed out previously that stock markets cycles are *primarily* determined by fluctuations in price/earnings ratios (P/Es). For example, in terms of *stock prices*, the long bear market which started in 1965 bottomed out in 1974. But in terms of P/E ratio, it only bottomed out in 1982, eight years later. Of course, by then, the Dow Jones Industrial Average stood 33% above its 1974 bottom, but a 33% gain over eight years is not really spectacular. However, over these eight years, with the help of recovering earnings, the price/earnings ratio of the “market” had reached a rock-bottom level of around 7, and that is what allowed the stock market to embark onto its long bull run of the 1980s and the 1990s. ([“Phew”, you said?](#))

So, whether the current leg of this bear market bottomed out at 741 on the S&P 500 in November or it carries somewhat lower (Rosenberg, for example, thinks 660 would make sense), it is entirely possible that, in terms of stock prices, that will mark the low for this entire bear market. A second decline, possibly in 2011 if Kasriel’s scenario is on target, *may bring lower price/earnings ratios, assuming earnings write-offs have abated in the interim, but not necessarily lower stock prices.*

## **What is a low price/earnings ratio?**

Here, I would like to interject two caveats about using the very low price/earnings ratios of 1974 or 1982 as benchmarks for bottom-of-cycle P/Es.

First, P/E ratios are affected by interest rates, since stocks compete with *riskless* Treasury bills or bonds more for investors' dollars. Ten-year Treasury bonds offered yields of almost 8% in 1974 and over 13% in 1982. This, in part, explains why P/E ratios were lower then than they are today, when 10-year Treasury notes yield a paltry 3%.

Second, both these earlier periods were characterized by a preceding oil shock and by high inflation, particularly in commodity prices. As a result, whereas corporate profits normally decline in a recession (thus boosting reported P/E ratios), *in aggregate* they actually rose during these two recessions, thanks to booming profits in the oil-and-commodities-related industries.

For example, the *aggregate* earnings of the S&P 500 were 50% higher in 1974 than in 1972. The recession that followed the fall of the Shah of Iran in 1979 and the second oil shock soon after was really W-shaped, interrupted by a brief oil-related investment boom in 1981. But the S&P 500 earnings, while flattish in 1979-1982, were 20% higher at the 1982 market bottom than before the recession, in 1978.

At the moment, we do not have any extraordinary factor inflating earnings – quite the contrary in fact, since even oil-company earnings now seem to have topped out. Prof. Jeremy Siegel, at Wharton, points out that large write-offs have recently depressed reported earnings and thus boosted P/E ratios. He figures that eight companies accounting for less than 2% of the index's market value have aggregate losses that lower aggregate earnings by 29%. The other 492 stocks, with 98% of the market value, have a P/E ratio of only 12.8. This compares with the current P/E ratio of the total S&P 500 which, based on the individual estimates of Standard & Poor's own analysts, is around 18.

Many companies are still revising down their profit estimates to reflect the depth of the current, global recession. That is a normal, cyclical phenomenon. But the financial sector which, between 2000 and 2007 contributed 30% to 40% of the S&P 500 earnings is currently reporting *losses* equal to 10% of the index's earnings – mostly because of asset write-offs or mark downs. Clearly, they will not soon return to their contribution of the past decade, but neither will they forever continue to subtract from total S&P earnings.

So, no one is sure where earnings will stabilize after the current collapse. Probably not near the all time high of 2006 (\$87), which was artificially inflated by the phantom earnings of financial companies, but probably not either at the \$28 level which some economists are forecasting for this year – a figure that is heavily burdened by write-offs and asset-impairment charges.

## **The long view is getting better**

One way to figure whether stocks are reasonably priced is to look over the valley of current uncertainties. A number of analysts that have been more right than wrong over time try to assess potential returns from stocks over the next cycle. Among them:

John Hussman, of the Hussman Funds, who has long been cautious toward stocks because of excessive valuations, often calculates a price/earnings ratio based on the peak earnings of the S&P 500 in the previous cycle. He argues that earnings growth is cyclical, but that, *peak to peak*, it has been remarkably steady, at 6% per annum over the long-term. Calculating the market P/E ratio on previous peak earnings eliminates the cyclical factor and thus makes it possible to use the P/E ratio to assess probable investment returns over the ensuing 7-10 years.

Today, he is shaving some dollars from the previous peak earnings of nearly \$87 in 2006 to reflect the fact that some of these earnings, particularly in the financial sector, were clearly non-recurring. Using “normalized” earnings of \$65-\$70, he finds a P/E ratio of about 13, which is in his undervalued range for the first time several years. Although he would prefer a P/E ratio of around 9 as a prelude to a very strong advance and he cannot completely rule out somewhat lower market levels over the next couple of years, he believes that long-term investors could achieve reasonably good total returns in the area of 10% annually over the next 7-10 years. (Weekly Market Comment – 2/9/09)

Jeremy Grantham, of GMO, also has been cautious about equities for quite some time, as he accurately chronicled the excesses that needed to be corrected in our economy and financial system. Though he acknowledges the possibility of a further market decline, as “markets love to overcorrect to the downside after major bubbles”, he is “bullish again”. He evaluates the potential return on the S&P 500 over the next 7 years at around 7% annually compounded *in real terms* (after inflation). (Barron’s -- 2/8/09)

Jim O’Shaughnessy, of O’Shaughnessy Asset Management, points out that if the S&P 500 compounded at *only* 6% per year from now through the end of 2019, the twenty-year return through 2019 would be worse than in the twenty years following the Great Depression. Judging that “stocks are cheaper than they have been in a generation”, he concludes: “A crisis is a terrible thing to waste”. (Market Commentary – 1/20/09)

## **Conclusion**

Stock market bottoms are associated with much uncertainty and a constant flow of bad economic news that usually outlast these bottoms by many months.

Pinpointing the exact timing and level of a market bottom is an almost impossible task. But when history and valuations start pointing to reasonably attractive future long-term returns is not the time to give up on the stock market.

The possibility of a W-shaped recession and stock market double-bottom within the next two-to-three years should not make us forget that a second market decline, following an initial recovery, might bring lower, more attractive valuations, *but not necessarily lower stock prices*.

As (and if) the “W” unfolds, things will become clearer and the leaders of the next, long-term stock market advance will emerge. It is not too early to stop paying attention to the overall behavior of “the market” and to focus more on the valuations and fundamental prospects of individual companies.

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