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The Dreaded "R" (and "I") Word(s)

With a Little Optimism on the Horizon

Recession or inflation (or both)? Throughout 2007, the subprime fiasco and rising oil prices highlighted the business news and created contrasting negativity for the economy. The subprime lending mess served to stall any projected housing rebound and a virtually "who's who" of global financial mega-firms got caught up in the expanding credit crisis. Other sectors of the economy like manufacturing and even labor began to show signs of slowing as well. Recessionary fears emerged and some pretty noted economists began assigning percentages to its likelihood. (For the record, Fed Chairman Bernanke has not predicted a recession at this point.)

By contrast, oil prices soared throughout 2007 and $100/barrel could not be overlooked from an inflationary perspective. With average Joes (and even rich Joes) facing higher gas prices, the newfound energy crisis took its toll on their pocketbooks and retailers began crying "gloom and doom" heading into the holiday shopping season and beyond.

What's a Fed Chair to Do?

The dueling crises created some dilemmas for Chairman Bernanke and his cohorts at the Federal Reserve. On one hand, the credit concerns suggested that rate cuts were in order to inject liquidity into the system and improve the borrowing abilities of businesses and consumers alike. On the other hand, such an accommodating monetary policy could prove disastrous if inflationary pressures were truly heating up. When all was said and done, the credit issues won out and the Fed followed up its one half percent rate cut in September with two additional quarter percent cuts in October and December.

As the recent round of data in 2008 revealed further weakness, the recessionary fears went global and the world markets plummeted in mid-January. Record defaults and write-downs brought financial services firms to their knees and served to prolong the never-ended sluggish housing sector. New home sales plummeted to levels not seen in 12 years. The consumer remained worried as its confidence level plunged as well. In January, the economy actually lost (nonfarm) jobs for the first time in four years. Likewise, 4th quarter GDP rose by a mere 0.6% (from a whopping 4.9% in the 3rd quarter) and suffered its worst year since 2002. To add insult to injury, wholesale inflation or PPI soared by 6.3% in 2007, its largest increase in 26 years. On the (somewhat) bright side, energy prices have declined in recent weeks as recessionary fears threaten to reduce the overall demand for oil in the months to come.

With the stock market (and economy) seemingly in free-fall, Bernanke and the Fed again sprung into action with a surprising inter-meeting rate cut of three-quarters of a percent to add further liquidity to the system and help calm nervous investors, borrowers, consumers, business execs, and virtually everyone else. One week later, the Fed cut rates another half a percent to 3.0%, its lowest level since June 2005. Some analysts praised the moves as Bernanke instilled confidence that he is prepared to do "whatever it takes" to right this economic ship. Others lashed out at him and his cohorts, claiming that he was letting investors dictate policy and his moves served to bail out many of the wrong-doers who brought about the mortgage debacle and credit crisis. The debates about appropriate Fed actions were accompanied by enhanced concerns about a recession. Bear in mind, by true definition --- two consecutive quarters of negative growth --- a recession is not upon us (but may be getting close).

An Optimist's Perspective (for a change)

For some who believe that a recession is inevitable (or even already in our midst), all hope is not lost. For one, Chairman Bernanke and his "team" at the Fed have proven that they are intent on doing everything in their powers to limit the ongoing negative ramifications. Likewise, Treasury Secretary Paulson, a seasoned Wall Street veteran himself, has indicated as much from the Administration's perspective. The President and Congress have tried to set aside traditional partisan bickering and finger pointing long enough to come up with an economic stimulus package (that is actually more substance than fluff). While financial firms have been reporting record write-downs and losses, much of the worst news may have been brought to the forefront (hopefully) and certain global investors have offered them some much-needed capital infusions.

While so-called experts debate the probabilities of a recession, the more important question involves its exact timing. In fact, those who believe the country is already mired in such a downturn (despite the traditional definition) have offered some controlled optimism that stock prices may be close to bottoming out (wishful thinking, perhaps?) and bargains are beginning to emerge. Some claim that the period immediately preceding a recession often proves more detrimental to markets than the actual recession itself. (Sell the rumor, buy the fact?) After all, financials and housing stocks have been beaten up pretty good over the past year; certain retailers lost significant ground during the holidays, and dwindling consumer confidence has threatened other sectors as well. On a positive note, some global industrial and basic materials companies have benefited from rising exports due to the plummeting dollar.

Let's Go To The Numbers

The National Bureau of Economic Research states that the average recession since World War II has lasted 10 months and stocks held up quite well during those periods. In fact, in three of the past four recessions, equities actually increased in value overall. Of note, from July 1990 to March 1991, the S&P 500 index rose 2.5 percent; from January 1980 to July 1980, stocks climbed by almost six percent.[1]

While the S&P 500 had already plunged over 15% from its peak in October, Ned Davis Research implied that some tremendous buying opportunities may be in the works. In fact, according to its research, over the last 10 recessions, stocks have skyrocketed by an average of 24% within six months after hitting their lows. Of course, we don't know whether the indexes are approaching their lows, but if history proves anything, overreactions do occur and adversity often leads to opportunity…another argument for staying put, not panicking, and investing for the long haul.

[1] *New York Times* 1/20/08

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