

US Recessions

How Quickly Can Markets Recover?

By John Robertson

Equity markets have usually anticipated changing conditions and have begun to improve well before a recession has ended but markets are moving with increasing speed in response to changing circumstances.

The aim of this note is twofold: to summarise the historical connection between US economic recessions and the timing of movements in equity prices and, secondly, to discuss the likelihood of markets responding more quickly to changing economic circumstances than they have in the past.

As we depart 2008, a year which has been characterized by one of the most dramatic market declines in decades, we start turning our minds to 2009 and the possibility of more benign market conditions.

While there has been much written in recent years about the pivotal role of China in setting the pace of global growth, the events of the past year have demonstrated quite conclusively the importance of the US economy.

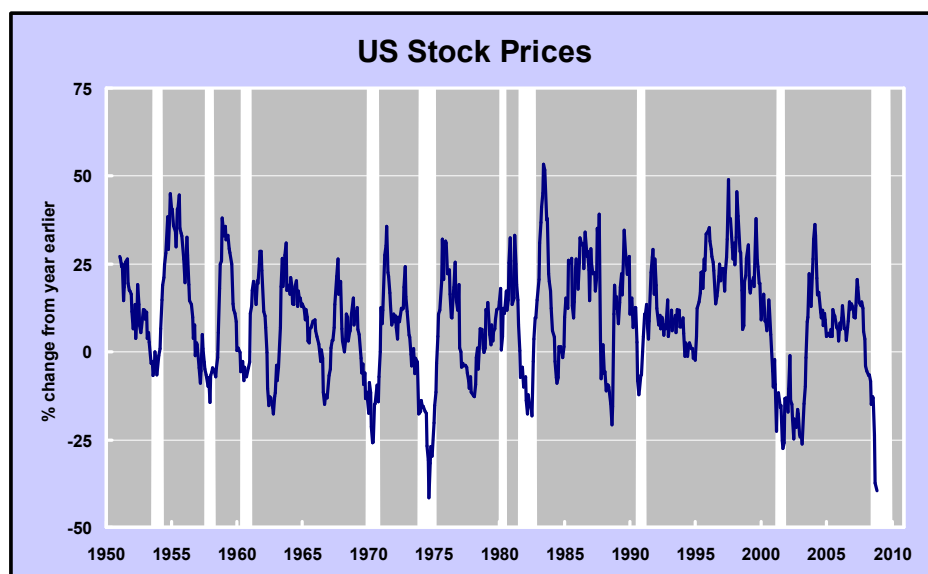
There is little doubt that a global recovery, whenever it happens, will depend on the pace of US growth accelerating. Equity market activity around the world might also be affected by local conditions but it is hard to see sustained strength in international markets as long as US markets are struggling to recover.

Between 1950 and 2008, there have been ten officially designated recessions in the USA, according to the prestigious Washington-based economic think tank, the National Bureau of Economic Research (NBER).

Although commentators informally characterize a recession as a two-quarter contraction in real gross domestic

product, for the NBER a recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production and wholesale-retail sales. A recession begins just after the economy reaches a peak in activity and ends as the economy reaches its trough.

As the accompanying table based on the NBER recession timing data and S&P 500 stock returns shows, the average duration of US recessions over the past 55 years has been 11.3 months. In each case, the stock market bottom occurred part of the way through the period of the recession. The average time period between the beginning of the recession and the bottom of the stock market was



The chart shows movements in the U.S. S&P 500 stock price index since 1950. Superimposed on the share price movements are highlighted blocs of time to illustrate the timing and duration of each of the nine NBER designated recessions.

Each of the nine completed recessions has coincided with a fall (and subsequent recovery) in stock market prices. In each case, the market has anticipated the impending contraction in output and commenced to fall before the beginning of the recession.

The average market fall associated with these recessions has been 20.5%. To the end of November 2008, the S&P 500 had fallen by 42.7% since reaching its peak value 13 months earlier in October 2007. There was a comparable fall associated with the recession of 1973/74 when the market fell by 46.2% over 21 months.

6.7 months. On average, the stock market reached its low point 57% of the way through a period of recession leaving it in recovery mode for just over 40% of the duration of the recession.

Aside from the historical interest, that still leaves us having to make a judgment about how we are positioned in the current cycle before we can draw any inferences about the timing of possible market recoveries.

Commentators are suggesting that the U.S. economy could continue to contract until the middle of 2009, approximately equalling the duration of the 1973/74 and 1981/82 recessions, the two longest since 1950.

Given surrounding circumstances, the current recession could last longer than these. Nonetheless, based on the historical connections between recession and market performance outlined above,



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a recession lasting until the end of 2009 (i.e. 24 months since it began in December 2007) would be consistent with a market reaching its bottom and beginning a recovery in February (or thereabouts) 2009.

That might be a best case scenario. According to the NBER, the Great Depression, to which our current circumstances are frequently being compared, lasted 43 months. If the current recession is closer in character to the Great Depression than anything we have witnessed since the 1930s, it would last into the first half of 2010, at least, and push a market recovery correspondingly further into the future.

But governments are doing as much as they can to ensure that the Great Depression is not repeated. Their actions might be creating other imbalances, including a mammoth funding task to be dealt with in future years, but there appears to be an unusually concerted determination to drag economies out of recession during 2009.

The emerging wisdom is that a 2009 market recovery, if it eventuates, will be less strong than the fall in equity prices during 2008 because less debt will be available as banks are forced to restructure their balance sheets. However, three factors unconnected to the state of bank finances have been speeding up the pace of financial market decision-making.

q Technology is making the world smaller. The London Metal Exchange forward contracts were originally set at three months because that is how long it once took for information about shipments to get from the new world to Europe. Today, to the extent they wish to have it, everyone can have access to the same information just a few seconds short of instantaneously.

q Investor numbers have been growing. The demise of the centrally planned economies and looser government constraints on international capital flows have introduced more people to investment markets. Since investors are inclined to follow the crowd, there are

now more people shifting money in any given direction at any point in time.

q Markets have become more closely linked through economic specialisation. The world has accorded China special status as a global manufacturing centre. New York remains the global financial centre. The fortunes of one depend very much on the other. Japan, the Middle East and China depend on London and New York to reinvest their savings.

Nowadays, even a minor price signal in a London or New York market has wealth implications across the globe. Changes in sentiment are transmitted swiftly around the world forcing people to make quick decisions about their responses. The easiest response is often to endorse the conventional wisdom and, in following the herd, magnify the size and speed of market movements.

In this new world order, investors might acknowledge that the effect of today's news will be transitory but risk a loss of wealth if they do not react to the news by joining all the others being forced to make similar judgements at the same time.

This much is history. The question now is whether markets rise just as quickly as they fall for the same reasons.

During one day at the end of November, we saw the Australian market rise by 6.1%. The S&P 500 rose by 8.1% little more than 12 hours later when the US markets were open. In the very short term, markets are clearly prone to move up just as quickly as they have moved down.

However, if reaction times are permanently faster for the reasons outlined above, a return to historically high gearing might not be a necessary ingredient to realign equity prices with prospective earnings.

No doubt, a strong banking system is necessary to support economic activity. Most likely, also, the higher the amount

of lending, the more profitable business will be.

For any given level of profitability, however, confidence about future earnings might be a far more important ingredient in setting prices than higher debt levels. Higher debt might be more important in sustaining market turnover

Recession Beginning	Recession Duration (months)	Months to Stock Market Trough ¹	Falling Market (% of recession) ²
Jul-53	11	2	18
Aug-57	9	5	56
Apr-60	11	7	64
Dec-69	12	7	58
Nov-73	17	11	65
Jan-80	7	3	42
Jul-81	17	13	76
Jul-90	9	4	44
Mar-01	9	7	78
Dec-07	tbc	tbc	tbc

1. From beginning of recession
2. Proportion of recession completed before stock market rise commences

than in setting prices, an important distinction in considering the health of equity markets.

Admittedly, this is simply conjecture. Economists and financial analysts work best when the changes they are analysing fall neatly into historical patterns. When new patterns are forming, they are less certain about the possible outcomes.

That said, judgments about whether reaction times are going to be longer, shorter or unchanged will be critical to investment returns in the coming year. Whether they end up doing it implicitly or explicitly, one way or another advisers will have to take a view.

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