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"Which Came First: Recession or Recovery?"

Over the Christmas Holidays I received many wonderful gifts including "Life" the autobiography of Keith Richards. That book has nothing to do with this commentary, but it was a great read and I sprinted through it. Much to my surprise, Keith Richards is anything but a typical junkie – he is extremely cogent and intelligent and over the last 50 years has made an amazing contribution to music, entertainment and culture. I recommend his book to you. I also received the autobiography of Mark Twain which is an enormous tome – 700 pages of dense text miraculously written 100 years after his death. It is like trying to read the Oxford English Dictionary. I've barely ventured to open it yet, but it caused me to remember one of Twain's great quotes: "History may not repeat itself, but it sure does rhyme a lot!"

And that brings me to the topic I want to discuss today which is based on the age old philosophical question: "Which Came First: Recession or Recovery?" I'd like to briefly examine the definition and history of these two conditions in an attempt to discover the answer.

The definition of economic recession has evolved somewhat over time – *by the way, many people think Charles Darwin wrote that only the strong survive - he really said: "It is not the strongest of the species that survives, nor the most intelligent, but the one most responsive to change" – this lesson may be well applied to investing* – back to the subject at hand, the National Bureau of Economic Research is the government entity charged with declaring when recessions begin and end. While various data is evaluated, they generally consider recession to be two or more quarters of negative economic growth. Economic recovery is not precisely defined, it is simply something other than recession and therefore, necessarily, the rate of economic growth in periods of recovery varies widely.

Since 1790 there have been as many as 47 recessions in the United States - don't worry I'm not going to drag you through the history books. The point is that recession and recovery are more or less constant conditions and while we strive to limit and moderate economic declines we must constantly adapt to them.

Using NBER data, from 1854 to 1919 there were 16 economic cycles. The average recession ran 22 months and expansions lasted 27 months. From 1919 to 1945 there were 6 cycles with recessions averaging 18 months and expansions 35. From 1945 to 2001 there were 10 cycles with recessions averaging 10 months and expansions 57 months. Based on this, it appears that modern economic theory has succeeded with cycles becoming less severe and expansions more durable.

Then suddenly, we were hit by the great recession of 2007-2009. The scope of this discussion does not allow time for a detailed dissection of the causes of this collapse, but it is generally agreed that it was the result of a protracted housing bubble; enabled and deepened by loose lending standards and a corrupt, greedy financial system. We endured negative GDP from the 1st quarter of 2008 through to the 3rd quarter of 2009 including economic contraction of over 5% in both the 4th quarter of 2008 and the 1st of 2009, the only time that has happened since the great depression.

Among other frightening events: the auto companies – except Ford – were forced into bankruptcy and bailed out; Bear Stearns and Lehman Brothers collapsed, AIG, FNM and FRE became money sucking vampires and Merrill Lynch was forced into a shot gun marriage with Bank America. In the fall of 2008, desperate to save the economic system, the US treasury in conjunction with the Federal Reserve board announced the Troubled Asset Relief Program and numerous others designed to stem the panic. They were joined in these actions by counterparts around the world in an unprecedented global effort. At the time, many, if not most, doubted the actions would be sufficient, taxpayers resented “bailing out” companies at the core of the problem and the government’s response was subjected to intense criticism. The Fed was accused of overstepping the bounds of it’s authority by conducting both fiscal and monetary policy.

While the cost of these acts was great and the pain severe, they have been stunningly effective. The economy has been successfully stabilized and repositioned for growth. Without the full scope of the stimulus, we might still be mired in recession, the federal deficit may have climbed to $2.5 trillion (currently $1.4) and unemployment may have risen above 12%. Consider this, TARP - which deployed around $800 billion to various government rescue plans – was initially considered to be money lost in the vacuum of the crisis. However, by March of 2010 it was estimated TARP would lose only $100 billion, by August that estimate was down to $50 billion and in November it was lowered to $25 billion. The program has actually earned about $35 billion in income over the last 2 years.

Of the $190 billion in TARP funds that went to banks, $194 billion has been repaid along with $23 billion in interest and dividends. GM has now repaid all government debt and half the public equity stake has been sold. Some of you may have bought stock in the recent IPO. Ford, GM and Chrysler are once again making some of the most technologically advanced, high quality vehicles in the world. It is a stunning turnaround and evidence of America’s ability to reinvent itself.

Recently, the Fed announced Quantitative Easing 2 – QE2 – another act many economic pundits and media commentators slam. I think the Fed has simply said: “Look, our cards are on the table. We will do whatever is necessary to prevent the economy from sliding back into recession.”

So, where do we go from here? When you look at the chart of DJIA returns going back to the 1850’s, you see the average return has been around 6.5%. Small and mid cap stocks have enjoyed slightly higher returns. There have been 4 periods of negative 10 year annualized returns over that time. During the civil war, in the early 1930’s, again in the late ‘30’s and from 1999 to 2009 (2010 was up by around 11% returning us to marginally positive 10 year returns). Many describe the last 10 years as a lost decade for equity securities and investors have fled to the safety of bonds which have now enjoyed a spectacular 30 year bull market. In fact, small and mid cap indexes returned 4-6% over the last decade and, if you were in the right sectors and had a contrarian orientation, you might have done significantly better than that. This chart also shows us that there is a general reversion to the mean following extended periods of outperformance or underperformance. I believe we are in the early stages of just such a period of opportunity now.

Corporate America is healthier than anytime since 1960 with something on the order of $1.9 trillion in cash on S&P 500 balance sheets. Earnings have outpaced expectations in every reporting period since the second quarter of 2009. The market trades at a modest price to earnings multiple of around 13X this year’s consensus earnings estimate of $96 compared to the historic average of 17. In 2010, over 1,700 companies in the U.S. increased their dividends by a total of $26.5 billion. This compares to a decline in dividend payments of $42.4 billion in 2009. The number of companies cutting dividends fell by 80%. For the S&P 500, dividends increased by an average of 8.6% after falling 21.5% in 2009. Sideline cash has been estimated at as much as $1.5-2 trillion dollars and investors are beginning to seek return on money not just return of money. As a result, mutual fund flows may finally be starting to turn towards equities rather than bonds.

However, there are legitimate concerns not just in the U.S. but elsewhere in the world as well. There are many fiscal issues to be addressed: Debt to GDP ratios in many developed countries are uncomfortably high as are deficit ratios. Unemployment also remains uncomfortably high and needs to fall meaningfully in order for full economic recovery to blossom.

If you look at data following the double dip recession of the early 1980's and again after the S&L driven recession of 1991, you will notice that it took about 2 years for unemployment to drop significantly. This is due, in part, to the nature of corporate downsizing in recessionary times. Large companies tend to eliminate workers nearing retirement age providing them with early retirement packages. These individuals go on the unemployment roles, but don't intend to re-enter the work force.

There are several predictive tools that tell us employment is beginning to improve in a substantial way. Over the past 18 months average weekly hours worked, average hourly wages, overtime worked and the hiring of temporary workers have been rising consistently. This makes sense: in an uncertain environment, but with rising demand, employers push existing workers as hard as they can, then hire temporary workers and only turn to full time employees when they are convinced the recovery is sustainable. Additionally, government data lags the real time formation of small businesses and small business hiring that takes place early in a new economic cycle.

I believe the next 12-24 months will bring accelerated job growth, steady dividend growth and higher than expected GDP. Unemployment could fall to less than 9% by the end of 2011 perhaps going as low as 8.5%. By 2015, I believe unemployment will be 6% or lower. GDP could rise close to 4% this year and financial markets will continue to advance.

Since 1960, on average, post-recession financial markets have risen 32% higher than their pre-recession peak. During this cycle, this could mean the DJIA exceeds 19,000 and the S&P 500 reaches 2,000 or higher. If you have exposure to the right sectors and individual securities, it may be possible to do better than this.

On that subject, past economic recoveries have always required leadership from the financial sector and this one is no exception: financials have rallied 156% from the market lows of March 2009 (+11% 2010). Other cyclical sectors have also performed very well with consumer discretionary up 135% (26% 2010), industrials up 127% (24% 2010) and materials up 120% (20% 2010). The laggards have been the sectors Wall Street strategists have been recommending most heavily: telecom +46% (12% 2010), health care +44% and Utilities +40%. Health Care and Utilities barely squeezed out positive returns in 2010. Sectors and companies leveraged to economic recovery continued to lead in 2010 and I believe will do so for the foreseeable future. However, once their top and bottom line growth rates begin to decelerate the market will transition to leadership from more defensive, stable sectors.

Emerging markets also present real opportunity. The economies of China, India and Brazil are growing at 6-8% and their balance sheets are in much better shape than so called "developed" economies. We must embrace the opportunity of trade and investment in these countries.

As for bonds, if economic growth is sustainable, rising rates are inevitable which means bond prices will go down. It you hold to maturity you will be repaid your principle, but the rate of return will be held to the yield to maturity. Currently, for 10 year treasuries that is about 3.3% (up from 2.5% just 8 weeks ago). Adjusted for inflation that is virtually no return at all. The real point is that this is a very important time to assess your asset allocation.

My last point is that the evolution of our economy from the agricultural age, to the manufacturing age, to the age of technology and the productivity enhancements brought by that, does not mean we have lost the benefits of past revolutions. Rather, I believe that we have been weaving a basket that gets stronger over time. Perhaps the next revolution will involve new technologies and methods applied to agriculture and energy making both processes more efficient and allowing us to tread more lightly on the earth that sustains us?

By the way, Scientists have discovered a protein in egg shells that can only be produced inside a chicken's ovaries. The egg can therefore only exist if it has been created inside the chicken…

In closing, I urge you to continue to protect and grow your nest egg because prosperous times are ahead of us!

Regards,

Terry