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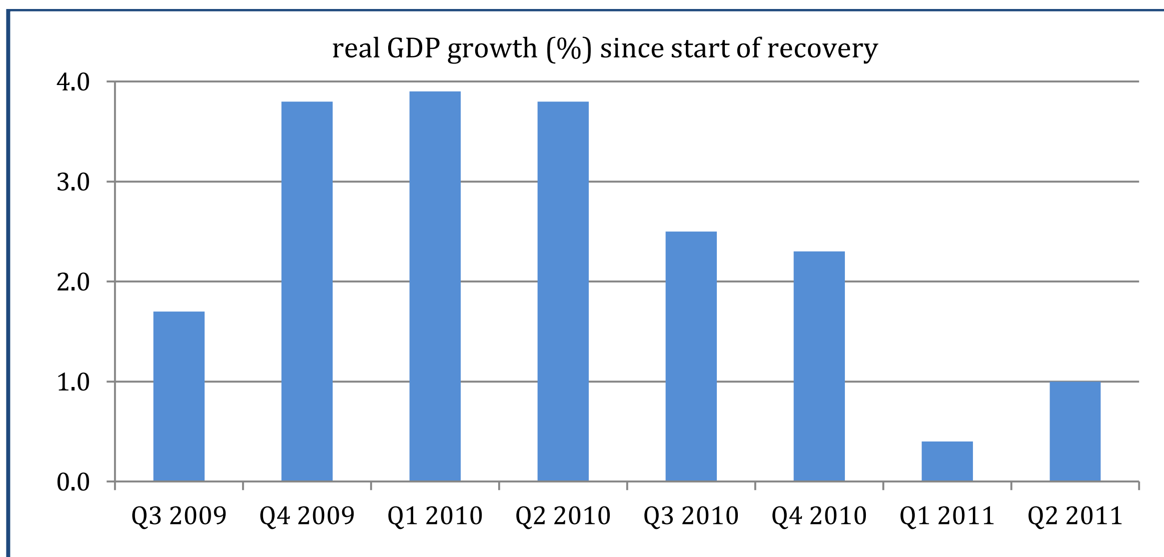
It's The Economy…

Well, it has to happen sooner or later. Bull markets do not run forever, not without a pullback, a severe correction, or a bear market. At this point, faster than you can ask "who ruined our summer vacation?", we are well past the pullback stage. With the S&P 500 falling 18% from its April highs, we are either near the end of a severe correction, or halfway through a bear market.

At times like these, the most common question becomes "what is the market telling us / what does it fear?". Is the problem a)the Euro-zone debt crisis, their care-free spending and half-baked economic union taking us down with them? Is it b)our dysfunctional government, finally exposed by the debt ceiling theatrics and downgraded by Standard & Poor's? Or is it c)the Arab Spring, or bad luck, or earthquakes and tsunamis and hurricanes all wrapped into one big natural disaster? For those keeping score, the answers are.. a)yes, to some extent; b)maybe, though not much; and c)not a chance, no matter what they say in Washington.

Mostly though, no matter how this market slump began, it is now about the economy -- the US economy -- the lumbering, stumbling giant that has evidently grown two left feet. The most telling data was the late-July revision of GDP figures. The new numbers show a recession that was deeper than previously reported, with a recovery bounce more shallow. Growth for the first half of 2011 was revised from nearly 2% to less than 1%.. and in a world where zero means flat-lining, that is scant cushion. The stock market reacted with haste, dropping 14% over the course of seven trading days. Clearly, to investors' thinking, something has changed. It's the economy.



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According to a old investment adage, the stock market has predicted nine of the last five recessions. Read that line again, taking care to appreciate its blend of humor and wisdom.

And here we are again, only it's not just stocks sounding the alarm. Treasury yields are at historic lows, corporate bond spreads widening, economists cutting their forecasts, while the Federal Reserve assures us of low rates for the next two years; these signals all point in the same direction -- a teetering economic recovery, on the verge of rolling over.

But is a recession inevitable, and for investors, does it matter at this point?

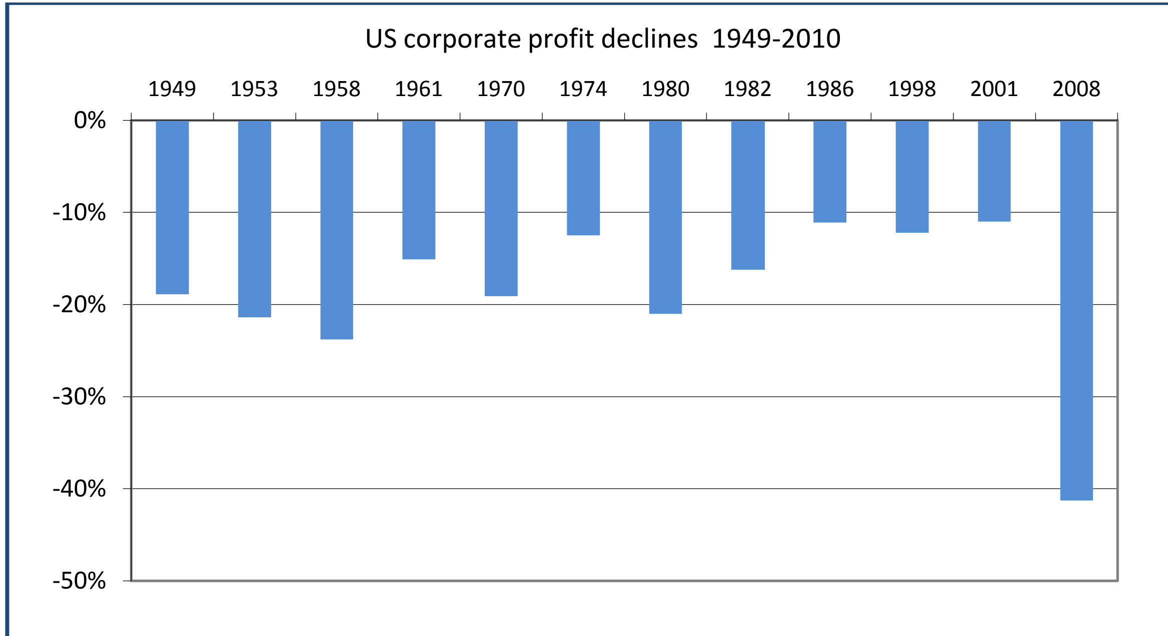
Before we proceed, a few disclaimers: Investors generally spend too much time worrying about the economy. Markets give faulty signals, while economic data is constantly revised after its usefulness has passed. The short-term linkage between economic growth and equity returns is often weak, at times counterintuitive. And we do not really invest in economies, we invest in companies. In the end, the investor's challenge is not to outguess the economy. It is to assess risk and reward, to identify winners, losers, and opportunities. The world is full of famous economists and famous investors. Seldom, if ever, are they one and the same.

So why bother? Because today, here and now, it does matter. With stocks down 15-20%, with earnings so strong, valuations so cheap, and interest rates so low, it matters dearly. Fiscal policy, monetary policy, dysfunctional government, Euro-zone debt troubles.. they all play into the equation. But in the end, when we put it all together, the critical issue at this point in time is the US economy and its growth rate over the next few quarters. It's a simple question, yet difficult to answer: Are we entering into another recession?

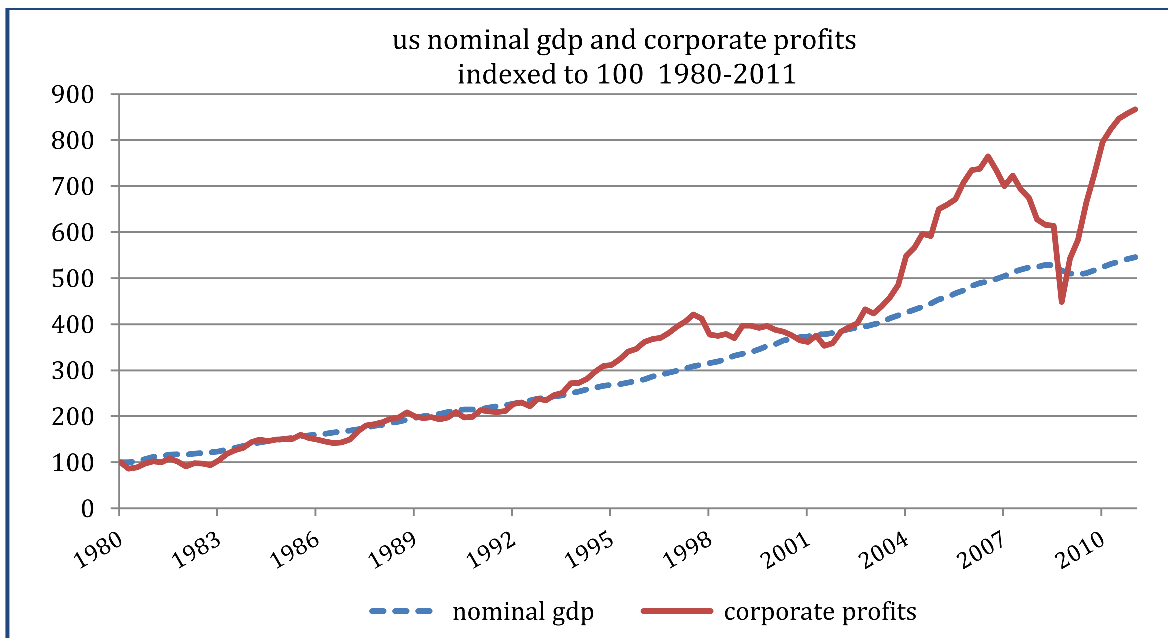
To be precise, when talking about a recession, for investors, it all comes down to earnings. We all hope for higher GDP, rising employment, lower deficits, peace and prosperity.. but what investors truly desire is robust profits. This is the major underpinning of what, for the past two years, has been a bull market in a fragile economy. Corporate profits have nearly doubled since bottoming in the great recession, the recovery driven by cost cutting, a weak dollar, low borrowing costs, and global expansion. Companies have recovered, even prospered, in the face of a most lackluster expansion. But there is a downside risk to the weak economy/strong earnings story. It cannot go on forever.

And what would likely stop it, right in its tracks, is a recession. There is a simple rule at work here.. in a recession, corporate profits decline; and when they do, stocks usually follow.

In the past 62 years, US corporate profits have experienced 12 significant declines, the worst by far being the recent collapse. Most declines are associated with downturns in the overall economy; a few are simply "profit recessions". Still, the message is clear: recessions crimp profits, and we would be hard-pressed to break the trend at this point.



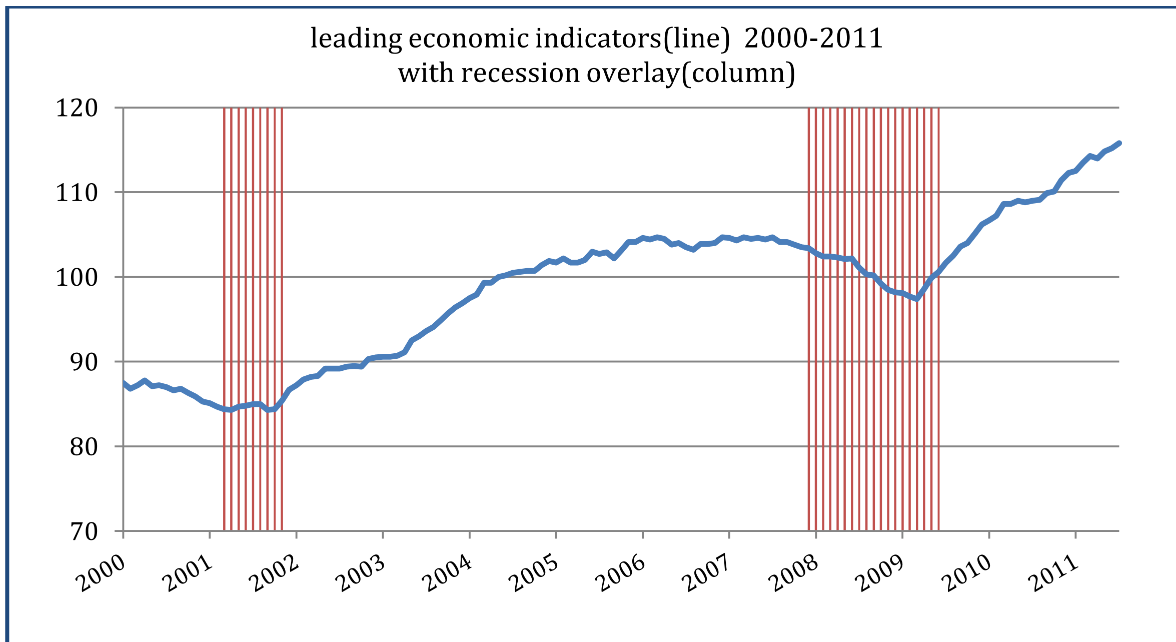
Over extended periods of time, corporate profit growth generally matches nominal GDP growth. The past two recoveries have been different, with profitability far outpacing nominal growth. This has been a boom for investors -- record earnings -- but also creates the risk of reversion to the mean if the economy slips.



As for the recession risk itself, this is a tough call. Most economists place the odds of a downturn at about one-in-three -- somewhat unlikely, but not with a comfortable margin. To be clear, the alternative is not prosperity, just a muddle-through scenario. The burdens of weak employment, over-built housing, and excessive debt will continue. For investors though, especially at today's prices, any forward progress is acceptable.

Of course there are clues to the economy's future, other than market warnings. Ask five economists for their favorite leading indicator, and you will receive ten answers; in many cases, justifiably so. One generally fail-safe signal over the years has been the Treasury yield curve -- it flattens or inverts ahead of almost all recessions. The problem with the yield curve today is that short-term rates are near zero, so yield curve inversion is impossible. So much for that signal.

Then again, there is a quick, easy and logical place to look for guidance, but that seems too simple. After all, no one is impressed when somebody states the obvious. Nevertheless, the index of leading economic indicators has a credible record of signaling trouble ahead. For all the disappointing economic releases -- and there have been plenty -- the leading indicators show no signs of a downturn. That may not provide the greatest of comfort, but for now it must suffice.



So where does it leave us? We are in the midst of a market slump, with various parts of the financial system showing strain, but not outright distress. A recession is possible, yet still unlikely. If it occurs, earnings will suffer and markets will weaken, but not forever. If not, stocks are cheap -- they are cheap on many measures -- and in time will work higher. It's never easy, but we have been here before. We will get through it again..

Sources:
Bloomberg
National Bureau of Economic Research

Only On Wall Street..

Silver screen antagonist Gordon Gecko put it bluntly.. on Wall Street, if you want a friend, get a dog. The street can be a cold-hearted place, and when it smells blood, anything goes. But still.

Of late, the popular target has been Bank of America. Recently an acquaintance in the business told me his firm had just downgraded the stock.
When asked for the analyst's name, he confessed he did not know it. A quick check of news sources showed no recent downgrades of the stock. Strange.
Another check revealed something even stranger.. the firm in question does not provide research coverage of Bank of America. Jeez!

Just when you think you have seen it all, someone goes and downgrades a stock they do not even cover. Is there a rule against piling on?

Post script: Precisely one day later, Warren Buffett announced a $5 billion investment in Bank of America. Apparently he missed the downgrade call as well.

Tidbits..

Job cutting targets:
UBS .. 3,500 jobs
Cisco Systems .. 6,500 jobs
Bank of America .. 10,000 jobs
Merck .. 13,000 jobs
HSBC Holdings .. 30,000 global jobs

For US labor market, the bad news continues.

Borders Group, once nation's second largest bookseller, begins liquidation.

40 years; 15,000 employees; 1200 stores .. to nothing.

Congress reaches budget/debt ceiling agreement, averts default.

Political theater ends, but spending problems continue.

Bank of New York Mellon begins charging customers for large deposits.

An upside-down financial world.

Apple CEO Steve Jobs steps down due to health issues; end of an era.
Apple matches Exxon Mobil as world's most valuable company.

And by far the most admired and loved. Don't worry, it won't love you back.

Hewlett Packard to restructure, drops Palm WebOS platform, may jettison industry-leading PC business.

A major course reversal, fading on the hardware business.

Mexico, University of Southern California join rush to issue 100 year bonds.

For every smart seller, is there a dumb buyer?

Congressional Budget Office trims current year fiscal deficit forecast to $1.3 trillion.

Only $1.3 trillion?

European Union revises bailout for Greece, second rescue plan in 15 months.
Italy and Spain briefly become new focus of concern, and intervention.
European leaders seek closer fiscal integration of Euro-zone nations.
Fears of European banking crisis grip global markets.

Leaders' dilly-dallying runs head-on into markets' ultimatum.

US credit rating loses AAA status at Standard & Poor's.

The emperor has no clothes, finally someone said it.