



# EARL M. FOSTER ASSOCIATES

I N V E S T M E N T M A N A G E M E N T

## NEWSLETTER

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### THIS RECESSION WON'T LAST FOREVER Is A Rebound On The Horizon?

**O**n average, the economy grows about three percent annually, but rarely three percent each year. Instead, the rate fluctuates in cycles. The decade of the 1990's, for example, began with a recession and was followed by an economic boom led by the technology sector. During the 1990's, inflation-adjusted growth (Real GDP) was an above-average 3.3%, with robust increases in employment and consumer spending. This prosperity was accomplished with fiscal discipline by the Federal government and reasonable household savings rates. It was an environment in which the stock market thrived, increasing an average 15.8% per year accompanied by earnings growth of 9.0% (Table I).

**TABLE I**  
**A Contrast In Decades**  
**1990's vs. 2000's**

*Estimated Average Annual Growth*

	1990's	2000's**
<b>The Economy</b>		
Inflation	2.1%	2.4%
Real GDP	3.3%	1.6%
<b>The Consumer</b>		
Borrowing	3.1%	6.5%
Savings Rate*	5.2%	1.8%
Employment Growth	1.8%	0.5%
<b>The Stock Market</b>		
S&P 500 Earnings	9.0%	3.2%
S&P 500 Price	15.8%	-0.7%

\*Average of year-end levels

\*\* Projected through year-end 2009

The current decade also started with a recession, much of it related to the aftermath of the technology boom. The shock of 9/11 and the costly war in Iraq further

hindered the economy. Fiscal and monetary policies were undertaken to restore economic growth. On the fiscal side, there were the 2001 tax rebates and the 2003 tax cuts. Both stimulated consumer spending, but the impact in each case was temporary. Credit standards for home mortgages were also eased to broaden home ownership and stimulate the housing sector. On the monetary side, there was aggressive growth in the money supply and interest rates were brought to the lowest levels in more than a half century.

These well-intentioned policies did sustain economic growth for much of this decade, albeit at half the pace of the 1990's. Employment growth became marginal, household balance sheets deteriorated with excessive debt, the sharp decline in savings rates left consumers ill-prepared for the latest economic downturn, and lax credit standards along with insufficient regulation of the banking system crippled our financial institutions. As a result, severe imbalances developed that led to the sharpest and broadest economic contraction in nearly 75 years.

Again, politicians and government officials are undertaking unprecedented monetary and fiscal measures to stabilize business conditions and prevent the current downturn from spiraling out of control. It is expected that these actions will prompt an expansion in capital spending by the private sector as articulated by Keynesian economic theory in the 1930's. Nonetheless, the level of indebtedness in the business and consumer sectors will temper spending in the coming quarters. On

the monetary side, the substantial increase in money supply and the sharp drop in short-term interest rates should have a positive effect on the economy, but more time may be required before its impact is realized. Thus, the seeds for an economic rebound have been sown, they are now in the germination stage, and gradual improvement or stabilization, at a minimum, in business conditions should emerge later in the year.

Before sustainable growth can be resumed, however, excesses and imbalances in the economy must be corrected, and this could take time. Excess inventory will continue to cause residential construction to remain at sub-par levels well into 2010, perhaps 2011. Weak employment numbers will prolong the recovery in home prices. The consumer sector, which represents 70% of the economy, will have a culture of frugality as households restore savings rates to more normal levels. In the finance sector, credit availability will be limited by tighter lending standards and efforts to repair bank balance sheets plagued with “toxic” assets. These factors will restrain the economic recovery and growth over the coming years is unlikely to achieve the pace of the decade of the 1990’s.

## INVESTMENT STRATEGY

As this deep recession matures, investors face a difficult set of asset allocation alternatives. The yields on low risk cash reserves are close to zero. Investment grade bonds offer better yields, but their attractiveness is tempered by aggressive growth in the money supply and an expanding Federal deficit that could create inflation risks in the years ahead. Stocks are selling at attractive valuations and have substantial recovery prospects, but the barrage of negative economic news has been disconcerting.

While stock market volatility is likely to continue, the depth of the decline and its longevity suggest that current market values reflect the severity of the recession. Moreover, the wide range of fiscal and monetary measures applied to stabilize the economy should suggest that a trough in business conditions is near at hand. As the normal lags from monetary stimulus work through the system and the economy begins to stabilize, stocks should react favorably.

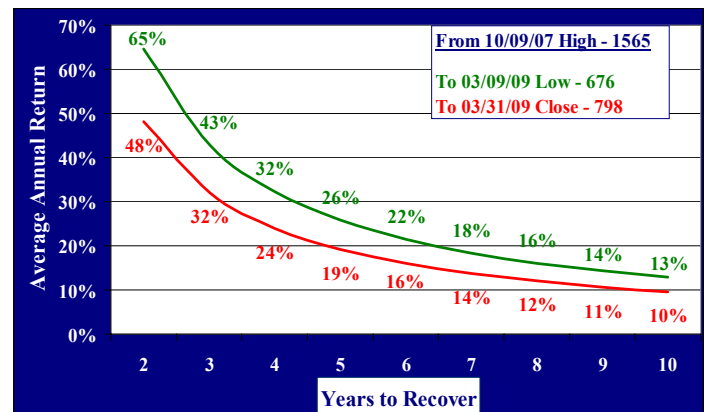
The recovery from severe bear markets can be substantial. Table II looks at the four most severe bear markets since 1935, and the length of time it took for the Standard & Poor’s Index to return to its prior peak. On average, there was a rebound to the prior peak in 5.2 years, and during that time, the Index appreciated at an annual rate of 14.8% (excluding dividends).

**TABLE II**  
Recoveries from the Four Worst Bear Markets  
Since 1935

Trough	Peak Date	Time Lapse (Years)	Average Annual Return
Mar-38	Apr-46	8.1	14.0%
Feb-48	Sep-50	2.6	14.3%
Dec-74	Jul-80	5.6	12.9%
Sep-02	May-07	4.7	18.0%
<b>Average</b>		<b>5.2</b>	<b>14.8%</b>

A substantial recovery can also be expected following this bear market. Chart I shows a combination of the number of years to recover and the respective average annual returns for the Standard & Poor’s Index as it returns to its 2007 closing high of 1,565 (green from the March 9<sup>th</sup> trough and red from the March 31<sup>st</sup> close). Even if it takes as much as ten years for the Index to return to its prior peak, the average annual gain (excluding dividends) would be 10% or more.

**CHART I**  
Projected Returns to Prior Market Peak  
Standard & Poor’s Index



On this basis, gradually adding to stocks is appropriate. However, equity investments should be confined to the larger, better-quality companies that are able to withstand additional shocks to the financial system should they occur.