

Note

RE: It Is Different This Time, But Not Economically.


Headlines remain dire. Unemployment is approaching 8% and is moving higher, GDP is contracting and the stock market has moved back to multi-year low territory. The real estate Bubble-Burst is ongoing with expectations of additional housing price declines in the 5-10% range. Distressed mortgage holdings have devastated bank balance sheets, creating a widespread banking crisis. While the facts above are quite serious, our collective perception of the severity of this economic crisis is outsized. This exaggerated perception of reality is due to a number of factors, to be addressed below, and can cause regrettable investment decisions.

Prior to 1930, it was relatively common for Recessions to turn into a Depression. The definition of a Depression is somewhat debated, but generally they last much longer and have much deeper GDP declines. Whereas Recessions typically last 1-2 years, Depressions tend to run five years or longer. Particularly long-lived was the 1873 to 1896 Depression lasting 23 years. GDP declines during a Recession typically total several percentage points, whereas declines during a Depression are much greater. During the Depressions of the 1930s, GDP declined 33% from 1929 to 1933 and then another 18% from 1937 to 1938. Unemployment rates also vary considerably between the two, with 9-10% peak unemployment being common for a Recession as compared to 25% unemployment during The Great Depression.

The most severe Recession of the past 60 years was the one of the early 70s, which lasted 16 months, had a total GDP decline of 4.9% and unemployment a touch above 10%. Expectations for the current Recession are for something comparable, though somewhat longer in duration. The reason for the extra length is that this one officially started Jan08, despite the fact GDP continued to grow during the first part of last year. Move the clock forward to when GDP declines actually began and the duration of this Recession is expected to be fairly comparable.

So why have there been no Depressions since the 1930s? Prior to 1946, currency was based on a Gold Standard, which meant that countries couldn't spend money they didn't have to counteract an economic downturn, and Trade Wars routinely ignited as countries tried to protect their domestic industries. The move away from a Gold Standard was designed to provide countries with more spending flexibility. Funding wars rather than dealing with economic crises was the main impetus for this change, but John Maynard Keynes found an important secondary use for that monetary flexibility. Keynes advocated government intervention to stimulate weak economic periods and to dampen overly strong ones, and it has been government's implementation of his theories more than anything else that have eliminated Depressions.

Our massive spending response to the current crisis is pure Keynesian, yet investors remain concerned that this Recession could get out of hand, which brings us to the examination of why our perception is so skewed. Realizing that gloom and doom are natural emotional responses to an economic crisis, why do so many feel this is "the worst" they've ever endured?



For those younger than 30 years of age, this is indeed their worst Recession, as it's been 25 years since our economy has weathered a major Recession. In fact, more than half the current workforce has not endured a full-blown Recession during their adult lives, as the Recession of the early 80s was the last one of those. That 25-year period with only the occasional mild economic downturn has caused even the more senior amongst us to forget what a real-deal Recession is like, hence this one feeling so dreadful.

Another significant difference is the Information Age we live in. Walter Cronkite and his peers were the primary source of our news when we last endured a major Recession, and they built their reputations by reporting rather than hyping news. Today there are countless media channels, each one clamoring for our attention, with many more than willing to report whatever they must in the name of news to capture an audience. Sowing fear and greed is the great media attention grabber, much more so than delivering balanced news, and listening to this variety of news can tremendously distort our perception of reality.

Finally, most Americans were not involved in the stock market when we last endured a major Recession. That was back in the day when companies provided pensions, and for the vast majority, investing meant buying a CD from the local bank. With the shifting of investment and pension responsibility to the individual, today most investors are involved with the stock market at least to some extent, and witnessing the devastation of their portfolios adds tremendously to the stress of the situation.

How we respond to the pervasive feeling of despair will determine more than anything else how damaging this period proves. Our economy has demonstrated through time its resilience to economic downturns, it is extremely unlikely given our Keynesian response that this fiasco will morph into something worse than a Recession, and soon despite our exaggerated perceptions, stocks will rally. Staying the course and capturing that rally and the market moves beyond is the road to recovery. We've endured too much and are too close to that ultimate rally to choose any other course.

Keep the faith!

Lowell D. Pratt, Jr., CFA
President