

Economic Recovery — how robust is it?

Leading economists, by and large, predict that recovery from the current severe recession will be listless, sporadic and jobless. However, there is a case to be made for optimism. James Grant, editor of Grant's Interest Rate Observer, is typically among the most bearish of economists, but he has recently turned into a raging bull.

His rationale is that, if you study history, the deeper the slump, the stronger the recovery; there are no exceptions to this rule, back to the Great Depression. And certainly this recession has been a deep one — compared to the downturns of 1990 and 2001, which brought losses in real GDP of 1.4% and 0.3%, this one has resulted in gross domestic product dropping a huge 3.9%.

Likewise, Laszlo Birinyi, head of Birinyi Associates, a stock market research firm in Westport, CT, believes we're in the early stages of a classic bull market that has plenty of room to run. His thinking is that the economic weakness we're experiencing has been so well documented that the market has already discounted it. "The negatives are right in front of your nose," he said. "The market is looking past it."

The problem with perception, according to Grant, is that investors tend to exaggerate both the positives and the negatives in the business cycle. According to English economist Arthur C. Pigou, "the error of optimism dies in the crisis, but in dying it gives birth to an error of pessimism. This new error is born not as an infant, but as a giant." In other words, it's easy to fall into the trap of both pessimism and optimism; but the best mindset for investors is to dispassionately study the facts and the history and make a rational judgment.

Growth snapped back following all recessions and depressions of the last century plus. In the first full year of FDR's administration (and the first full year of recovery from the Great Depression), inflation-adjusted GNP spurted by 17.3%. Likewise, in the four years that followed 1933, the economy grew at a 9.5% rate, while unemployment fell by 10.6%.

Our recession resembles more closely the one of 1980-82 rather than the Great Depression. In the first 3 months of 1982, real GDP shrank 6.4%, which matches the steepest drop of the current recession. Subsequently, the next 6 quarters grew at an average of 7.7%. That contrasts starkly with a recent survey by Bloomberg News of economists, who guessed, on average, that 2010 GDP would be only 2.4%.

What this tells me is that, even though the world is poised for disappointment, the world may end up being surprised. What I mean is that growth in 2010 is likely to surprise by its strength, not by its weakness.

Even so, we must remember that the future is basically unknowable and that all our forecasts for 2010 may end up being way off the mark. So what I plan to do is to skim profits about every six months (more frequently if market conditions warrant it) from each of your sizable stock fund holdings. So any of you that have not had your portfolio rebalanced in recent months will be getting an email from me soon with recommendations for taking profits. What this will serve to do is allow each of us to continue participating in the recovery (and the stock market rise that may accompany it), while being cautious and prudent by not letting us get over-exposed to stocks.