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The shape of the recovery

Since so many are focused on back-to-school activities in the beginning of September I think it is fitting to review the alphabet our economists are using in their discussions of the upcoming recovery. Most economists are on board agreeing that the recession is abating and that we will emerge sometime in the near future. That's the easy part. The hard part, which of course nobody can know the answer to, is what does the recovery look like

This is where the alphabet comes in. Economists use a wide variety of letters and even symbols, in this case, to describe the economy's entry and recovery from recession. The two most common letters are 'V' to describe a very quick slide into recession with a very quick rebound back to normal and 'U' to describe an equally quick slide into recession but a substantial delay before a rebound. The current recovery is leaning towards the 'V' shape thanks to the bailouts and stimulus programs.

There are two other substantially less appealing shapes we might have to contend with. First is the 'W', which has nothing to do with our ex-president. The W, as you might suspect it's just two V's back to back and is also known as a double-dip recession. This one is really no fun at all as the economy proceeds to dive back into deep recession just as we get our hopes up that life is getting back to normal. The second, and perhaps more likely for this round, is that often dreaded symbol from math class, the square root symbol. That's the one that starts out like a V then goes flat. It's not pretty but it sure does beat some of the alternatives.

We don't know what's going to happen. The good news is that a recovery from this deep recession is at hand. The combination of a massive stimulus package and swift decisive action by the Federal Reserve have pushed this recession through its phases quickly. The stock market has reacted positively to this in recent months which is also good news but the market could easily get ahead of economic reality. We also have the months of September and October (historically the most dangerous) to survive. My indicator is at 80, a level it has been at only 16 times since 1955. The last time, in 2003, it topped out at 86 so there is still some room for increases in the major indexes but a significant amount of risk in the markets as well.

One piece of data that concerns me is the current P/E ratio on the S&P500 index. A normal range for the P/E ratio is 7 - 20 with occasional readings in the mid and upper 20's. The Dow is pushing towards the top of the normal range but the S&P is recording levels of 120 on reported earnings. Earnings at smaller companies have been devastated by the recession so they have got to start reporting substantially more earnings pretty soon for this ratio to get back to a comfortable number.

The President has reappointed Chairman Bernanke to another term way before the current term expires. This is a good move on the Presidents part. Bernanke has done a masterful job earning the respect of all the worlds' central bankers for his handling of the recession. In addition, by reappointing him now, the President reduces uncertainty in the financial markets.