



Uncharted economic territory leads to historic buying opportunity

By Robert W. Landaas

Coaxing the bear

As I write this article one week after the 2008 U.S. presidential election, U.S. equity markets are close to their lows for the year. The endless parade of disappointing economic news suggests a recession that will be deeper and more prolonged than the 14-month average since the end of World War II. Most of us are navigating uncharted territory. Forecasting is almost always difficult; none of us thought things would get this bad.





The current economic downturn will rival the worst recessions of the last 60 years. When the U.S. economy began slowing in the fall of 2007, many analysts believed the rest of the world would “decouple” from the problems in the United States and would continue growing, helping to pull the United States out of its downturn. Now, nearly every major economy has seen a sharp slowdown. It appears that Japan and most of Europe are in recession. Growth in China and India has clearly slowed.

In the last recession, which ended in November 2001, consumer spending in the United States remained fairly strong. Today, consumer spending is plunging, creating a global slowdown. The American consumer is no longer able to carry the global economy. Current economic realities are pointing to a serious consumer recession. The worst housing bust on record and one of the worst bear markets of the last century are clearly taking a toll on spending.

Most economists forecast that consumer spending will contract sharply in the fourth quarter and is likely to fall in 2009, a first since 1980. Auto sales were the worst in 25 years in third-quarter 2008 — sales of new vehicles fell 32 percent. The jobless rate jumped to 6.5 percent in October, a 14-year high, and analysts expect the unemployment rate to exceed 8 percent this year. As job losses climb, retail sales have declined. Many retailers suffered double-digit declines in October sales, the worst in decades. Economists now forecast the U.S. economy to shrink at an annual rate of 4 percent in the fourth quarter and to fall 2 percent in each of the first three quarters of 2009 before a gradual recovery begins.

I have made a lot of money over the last 30 years by investing in stocks during recessions. Historically, half of all the money made in a bull market occurs in the 12-month period coming out of recession. In the last 60 years, stocks have hit bottom, on average, three months before a recession

ends. Many individual investors wait for the economy to show signs of improvement before getting back into stocks, looking for signs that things have returned to normal. As a result, they miss a significant part of the rebound.

It is difficult to buy stocks during periods of despair and pessimism. It is common for people to avoid danger and wait for conditions to improve. The maximum reward goes to those who realize that it is darkest before the dawn, not to those who think it is darkest before it is pitch black. Most professional money managers are very aware that stock prices start to recover before the economy does. In post-war history, the longest recession lasted 16 months, from November 1973 to March 1975. During this period, the nation struggled with an oil embargo, Watergate, and the war in Vietnam. Even if the current recession lasts two years, it still points to a recovery for the equity markets in 2009.

As measured by the S&P 500 stock index, stock prices have fallen 51 percent since the peak on Oct. 9, 2007. This decline is considerably worse than the historical average decline of 36.5 percent for bear markets. Based on numerous valuation measures, stocks are now selling at their lowest levels in 30 years. Too much emphasis is placed on Price/Earnings Ratio (P/E Ratio) comparisons, especially during a recession. Trailing P/Es and forward P/Es only focus on a single year, either the past one or the next one. A stock's value is determined by the sum of all the discounted cash flows for the company for years into the future. Nevertheless, the S&P 500 currently sells for nine times the mean estimate for earnings for 2009. Even at the low end of estimated 2009 earnings, stocks are selling at 12.4 times estimated 2009 earnings. A forward P/E of 12.4 gives you an earnings yield of 8.1 percent (the reciprocal of the P/E). The spread between the 10-year Treasury and the earnings yield has averaged 0.56 percent over the last 40 years; it's now more than 4 percent.

Relative valuations within the market suggest that large and mid-cap growth stocks represent the best bargains, selling now for less than 70 percent of their 20-year average P/Es. For the last nine bear markets, the sell-off lasted 14 months. With a market peak in October 2007, the market should be somewhere near the bottom.

On a final note, I continue to favor the international markets. Even though the U.S. dollar has strengthened recently due to the financial crisis, the staggering deficits in the United States will force the U.S. dollar to weaken again. Consumption in developing nations eventually will replace the American consumer as the economic driver of the global economy. Their robust demographic growth along with an increasing middle class and a high savings rate will help to propel their economies. In the United States and Europe, by contrast, there is no growing middle class and almost no net savings. On average, stocks outside the United States currently pay dividends at twice the level of the U.S. and have P/Es that are 30 percent below U.S. levels.

The economic news is bound to get worse before it starts to improve. Many investors are the victims of their most recent perceptions and tend to extrapolate their current fears too far into the future. Most of the bad news is already priced into the stock market. As the economy stabilizes, investors should focus on the eventual rebound in corporate profits. Long-term investors should take advantage of this unique, almost historic buying opportunity that stocks now afford. ● ● ●

ROBERT W. LANDAAS is president of *Landaas & Company*, an investment firm in Milwaukee. He can be reached at 414-223-1099 or Landaas@landaas.com.