PRAETORIAN GUARD

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Praetorian Perspectives

In this issue

ECONOMIC RECESSION

What is it *really* and how do we know if we are in one?

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TALKING HEADS, WORKING DEFINITIONS AND THE REAL McCOY

We can't turn on the TV today without hearing that we are in, just about to enter or unavoidably headed for a Recession. This contributes little to our understanding of the economy, its inner workings and what, *if anything*, we ought to adjust in our wealth management plan.

The anecdotal definition of a recession is when my neighbor loses his job, while a full blown depression is when I lose mine. More commonly, a recession is often *said* to occur when we experience two consecutive quarters of declining Real Gross Domestic Product.

Neither of these is entirely correct. We will attempt to shed some light on this timely subject in this issue of Praetorian Perspectives.

WHO IS THE FINAL ARBITER OF U.S. BUSINESS CYCLES?

Good news here—a private, non-partisan non-profit organization called the National Bureau of Economic Research (NBER) is our nation's economic "umpire," and has the immense challenge of identifying business cycle peaks and troughs. So while both political parties may find it to their benefit to bemoan economic problems OR extol the same economy's virtues, the actual decisions are made by independent economists.

Under the NBER's methodology, our economy must be in either an expansion or a contraction. The points where one state changes course is either a peak (end of expansionary period) or a trough (end of the contraction).

As expected, the NBER is monitoring economic data on a monthly basis, with total employment, real personal income less transfer payments, industrial production and the volume of sales in manufacturing and trade sectors of the economy being among the most important statistics it follows.

The reason for these *monthly* statistics is that they are both more timely and subject to less frequent revision than quarterly GDP or similar economic data points, and thus provide greater insight into economic inflection points.

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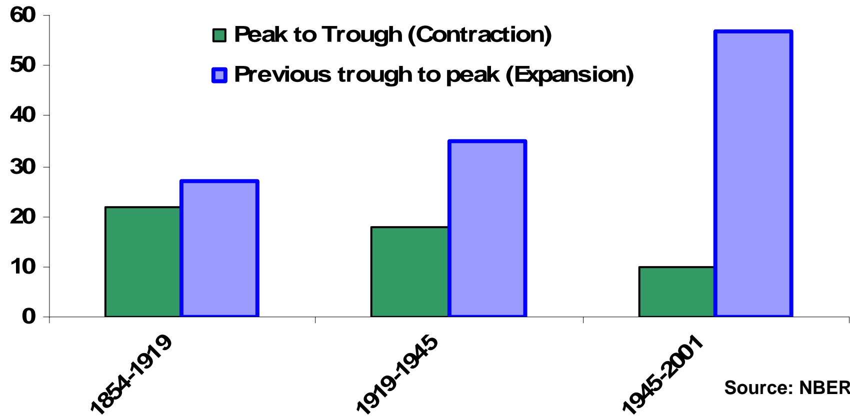
ECONOMIC EXPANSIONS AND CONTRACTIONS SINCE 1854
(Data displayed in months)



The above graph shows the duration, in months, of the 32 business cycles the United States has experienced since 1854. Because of significant changes in the US' economic development, world economic cooperation and integration, it is separated into three distinct periods. What we observe is that recessions have been getting shorter and correspondingly, expansions longer in duration.

CONTRACTIONARY PERIODS AND S&P 500 RETURNS

In the nine contractionary periods from 1950-2001, the majority of the S&P 500's decline came in the first half of the contraction (again because the stock market looks to the future, it is a better leading indicator than trailing), and the second half of the contraction saw solid returns as the economy righted itself.

Time in economic contractionary cycle as set by the NBER	Avg % Change in S&P 500 Return
START TO MID POINT	-7.82%
MID POINT TO END	+12.64%
1 YEAR LATER	+13.36%

Data Source: www.yahoo-finance.com & NBER

Where Are We Now?

While the official estimates have not yet confirmed that the US economy has entered a period of contraction, our analysis indicates that we are likely in the early stages of what will be a relatively short and not too deep recession. Currently we predict 12 months in duration, of which we may be 2-3 months into already.

The reality is that this recession will be similar to many past contractionary periods: the economic pain will be felt more acutely in specific sectors: financials and housing this time. The employment rate are 94.9% of the civilian labor force (or 5.1% unemployment) Continued high oil & gas prices will slightly depress discretionary consumer spending but not to such a degree that the main engine of the US economy (approximately 70% of GDP) stops spending.

HOW DOES THIS IMPACT FINANCIAL MARKETS?

One important point to understand is that the stock market is ultimately a discounting mechanism of future economic activity, so it is probable that the current slowdown/contraction has combined with the credit and liquidity crunch and dragged ALL indices down since November 2007.

But that also signifies that as the economy returns to its normal state of expansion, markets will respond earlier than lagging indicators such as employment, business investment and the related statistics.

This confirms that while the economic data is only clear in the rear window, the stock market looks to the future and thus by the time we KNOW we are in a recession, the stock market is already beginning to price in the expansion that inevitably will follow.

The significance of this is that exactly when investors "have had enough" is when we have likely reached the point of maximum pessimism and is the ideal time to buy.

The hardest time to stay in the market (a period like the first quarter of 2008) is exactly when we should be rebalancing our portfolio, keeping our sights on the long term because only one contraction since 1887 lasted longer than 24 months—the Great Depression of 1929-1933. We are a far cry from there today.

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