



# MONEY MORNING

105 West Monument Street Baltimore, MD 21201

## When and How the U.S. Economy Will Recover

**Though it seemed like we entered recession overnight, it'll be much longer until we emerge from it.**

**This report outlines when the U.S. economy will turn around, the effect of President Obama's policies and how to protect your finances in the meantime.**

If there's a proverb that captures the outlook for the U.S. economy, it's the one that says: "It's always darkest before the dawn."

The first quarter certainly presented us with some of the darkest days the economy and stock markets have seen in decades.

But when all is said and done, will they be the darkest?

### **Or are more to come?**

When the dawn does come, it will be one to remember. And if U.S. President Barack Obama gets it right, then investors will be presented with the greatest investment opportunity of our generation.

At that point, shares of American companies will be at such low levels that wholesale buying by individuals, mutual funds, pension funds, institutional money managers, and foreign-controlled sovereign wealth funds, will generate gains that will not only make us whole, they will make us rich once again.

Bet let's take a step back and examine every caveat of the U.S. economy – what President Obama is doing to fix it, and when economists believe the stock market and gross domestic product (GDP) will turn around.

We'll also show you how to keep your money safe – even bear market investments the pros are

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When it comes to banking or global economics, there's literally no one better than *Money Morning* Contributing Editor **Martin**

**Hutchinson**, who brings to the table the kind of high-level expertise that our readers have come to expect. Hutchinson was recently honored by *Slate* for correctly calling the Bear Market bottom. He also writes regularly for our monthly newsletter, *The Money Map Report*, in which he and other *Money Morning* colleagues also make investment recommendations for subscribers. To find out more about *The Money Map Report* – including a special offer that includes *The New York Times* bestseller, “[Crash Proof](#)” – [please click here](#).

making – until the stock market gets back on track.

## U.S. Economy/GDP

While many analysts expect U.S. corporate earnings and overall economic data to remain weak by historical standards, there may well be enough of an improvement over the prior months and quarters to spark some optimism that there are better times ahead.

For instance, a 5% to 6% contraction in first quarter GDP will look decent vs. the wrenching 6.3% decline the U.S. economy experienced in the fourth quarter. Mix in some still weak – but improving – corporate earnings season and there may be reason to hope that Obama’s prediction of an economic rebound in 2010 may not be off target after all.

The U.S. stock market has endured three protracted bear markets since 1900 (1906-1921, 1929-1942 and 1966-1982) and there’s evidence the United States may be ensconced on one of those periods again.

While there are some positive indicators, caution (or even cautious optimism) should be the order of the day.

Plenty of questions still need to be answered before we can proclaim an end to the bearishness and a definitive market recovery. This environment is not the time to be a hero.

But there are three significant wildcards at play here that could keep the market from sinking into an even deeper malaise – and that could, in fact, be a catalyst for higher stock prices and perhaps even an improved economy in the months to come. Those three wildcards include:

- There’s an estimated \$4 trillion in cash in investors’ hands on the sidelines – capital that could be drawn in to further pump up the markets, should the recent rally continue.
- The federal government has already committed to funding \$11.6 trillion in stimulus initiatives, and the sheer magnitude of that government intervention could play a substantial role in determining just how long this downturn lasts – or how quickly it ends.
- Stocks are, in many cases, currently trading at levels not seen since the late 1990s, meaning the market is dangling bargains too enticing to ignore.

Eddie Cohen, a market historian and chief investment officer for Stavis & Cohen Financial, believes that investors need to remain cautious and to understand that market sentiment can literally turn on a dime, especially if the volatility levels remain high. He also foresees some potentially positive developments on the horizon and believes that patient long-term investors who are willing to ride out the short-term volatility may want to commit some money to stocks in profit from these

low valuations.

Given that there is “an estimated \$4 trillion in cash on the sidelines right now... as investors become more confident, some of these funds could potentially find their way into equities and help drive the markets higher,” Cohen said.

## Obama Economy

Many commentators have described the current economic disaster as “difficult to understand.” But that’s not really true: The United States and the world in general are currently undergoing the inevitable aftermath of a decade of excessive money creation, from 1995 in the United States, and from 2001 for much of the rest of the world.

Not only did such a prolonged period of cheap money produce asset bubbles in stock, housing and commodities, it also produced a leverage bubble of excessive debt among consumers, businesses and financial institutions that must be wound down, an agonizingly painful process. The disaster was primarily caused by government, in particular the U.S. Federal Reserve and the (government-created) housing finance agencies Fannie Mae and Freddie Mac, but there’s no question that perverse management incentives in the financial sector, unsound new financial tools and sloppy regulation also played important roles.

During the election campaign, Obama and his supporters had great fun assigning blame for these troubles. Now it’s Obama’s job to come up with solutions.

What he has to realize – and he may already know this – is that there is a clear conflict between minimizing the current pain of recession and minimizing its duration. Actions that provide short-term relief generally create new problems that both delay the ultimate exit from the downturn and may cause a deeper economic “hole” before recovery takes place.

At first blush, the Obama administration seems likely to continue some of Bush’s economic policies. The second tranche of the \$700 billion TARP bailout has been used to support bank lending, homeowners and carmakers, while there is talk of a “bad bank” approach to dodgy mortgage-backed assets, similar to the original TARP plan, which would absorb hundreds of billions of additional bad assets.

By nature, he is a much deeper and more long-term thinker than President Bush, Bernanke or former U.S. Treasury Secretary Henry M. “Hank” Paulson. Obama also is surrounded by economic advisors Tim Geithner, Larry Summers and former Fed Chairman Paul A. Volcker, who all are committed to a free market rather than a government-directed economy – and who, in Volcker’s case at least, realize that short-term economic pain can be used to produce long-term gains that far outweigh it.

The recession of 1981-82, produced by Volcker’s tight money policy, was painful but highly worthwhile. The reason: It resulted in the disappearance of inflation and a period of almost recession-free economic growth that lasted a quarter of a century.

Thus, it absorbed its approximate parameters and would be badly damaged by the uncertainty such abandonment would cause. However, President Obama has already said that he sees the necessity of balancing the federal budget over the long haul, and with Volcker by his side he must realize that a similar course must be taken with respect to monetary policy.

## **Stock Market/Economy Recovery**

Eventually, say in 10-20 months, there will finally have been enough business failures, enough write-downs of bad debt, enough corporate layoffs, and enough foreclosures that the market will have hit bottom. With so much excess fat trimmed away, a reasonably lean economy will finally shed the excess weight needed to start getting healthy again.

However, the stock market will likely recover about six months ahead of the economy's actual recovery.

Here's the most likely economic recovery scenario to expect:

Due to a kind of financial or economic inertia that's so prevalent in a major recessionary environment like this one, the downward trends in the housing market, asset prices and job cuts will continue. That will force the federal government to push forward with the \$11.6 trillion in financing commitments that it's so far made, but not fully funded. It's also likely to bring out new bailout candidates – and to attract some repeat customers, as well.

That inertia is a major problem because it could create a vicious cycle that's hard to break. Take the job cuts. U.S. companies (and, increasingly, those in Europe and Asia, too) – fearful that the downtrend in profits and recessionary conditions will be with us for awhile – decide to get themselves into aggressive fighting trim, and carve off whatever fat they can find. Job cuts are the easiest way to cut costs en masse. So layoffs continue as long as the bad news persists.

And that would create a crisis in confidence for consumers. The jobless consumers pull back on their spending. Consumers who are still working are now fearful for their own jobs, and stop spending, too. When the source of 70% of your economy has gone into hibernation, the impact will be both widespread and deep. Corporate profits take another hit, leading to more job cuts, leading to additional profit declines... you get the picture.

It's now generally recognized that the Bush tax cuts played a huge role in the **burgeoning federal deficit and ballooning national debt**. But it's also generally held that President Obama has little choice but to cut taxes as he has.

Those tax cuts, coupled with the bailout infusions and the stimulus spending, **will have a secondary effect**, which again underscores why this turnaround will be such a challenge.

Just days before the Obama took office, the Congressional Budget Office projected that the U.S. budget deficit would nearly triple from last year's \$455 billion – and would reach a staggering \$1.2 trillion. And that was even before Obama unveiled his \$787 billion stimulus, bank-rescue and anti-foreclosure plans – or other fix-up initiatives that are sure to surface in the months ahead.

To finance that deficit, the government will have to borrow... heavily. In a market in which credit is already tight, stepped-up government borrowing can have the unfortunate side effect of “crowding out” private-sector borrowers, meaning corporations will have to pay much higher interest rates for borrowed funds – if that money is available at all.

That will affect companies in one, or both, of two ways:

- Companies will pay more for borrowed money, which will crimp their profits - and we’ve seen the unfortunate side effect of that.
- Or it will make it too costly, or even impossible to expand. Indeed, companies that are “on the bubble” in terms of solvency, may not be able to issue the commercial paper needed to finance daily operations, meaning they’ll be tipped into bankruptcy, and will have to cut still more jobs.

None of this will be good for stock prices, or for the banks, meaning the recession will continue to roll along.

**Bottom line: the economic recovery will take time. Again, look for the stock market to recover about six months or so ahead of the economy’s actual recovery. But expect the “rebound” under this hypothetical set of circumstances to be weak, long and slow. There’s even the potential for a “double-dip” recession.**

## How You Can Recover

Nat Levy, a principal with Houston-based McNeil, Levy & Friedman LP, is a five-decade veteran of the financial-services sector, and has seen his share of uncertainty. In the near term, it rarely pays to prognosticate – so he doesn’t.

The one prediction he will offer is that some investors will look back on miscues they made today with more than a little regret.

“Right now, we find ourselves in one of those ‘if only I had...’ periods,” said Levy. “My one educated guess is that in five years from now we’ll look back and think ‘If only I had invested in this; if only I had remained invested in that, etc.’”

Eddie Cohen points to the usual suspects like automakers and banks as industries that continue to face considerable challenges in the periods ahead. While he sees signs of renewed housing activity in terms of new and existing home sales, he acknowledges that prices continue to fall each month, foreclosures are increasing, and the newly laid-off workers could exacerbate those trends.

Cohen – like *Money Morning* – believes that **commercial real estate may be the next shoe to drop**; vacancies are increasing, rents are under pressure, and banks may not be willing to loan large sums of money to related companies looking to refinance.

Because inflation could become a problem, Cohen says investors should have some exposure to gold in today’s environment.

“The unprecedented level of government intervention has added significant liquidity to the marketplace, but, ultimately may lead to higher levels of inflation,” he said. “Gold can serve as a potential hedge against such price pressures. Additionally, as the country’s debt and deficit positions mount, the dollar could remain under pressure and gold can be viewed as an insurance policy against a weak currency and the uncertain times faced today and in the future.”

**Cohen states that investors can invest in gold** directly by purchasing bullion or through funds or exchange-traded funds – one being the iShares SPDR Gold exchange-traded fund (GLD) – that track the price movements of the so-called “yellow metal.” His firm uses a manager who buys bullions and stores it in a vault, which he says gives his firm’s clients the opportunity to access a product whose price moves more in lockstep with the market price of gold, and is even more cost effective than gold funds or ETFs.

In terms of stocks, Cohen believes investors should consider small-cap shares.

“Historically, coming out of recessionary times, small-caps are among the best performing equity asset classes,” he says. “Granted, many of these companies may have struggled during the dire economic times as investors shun anything other than industry leaders. Now may represent a decent time for cautiously optimistic investors to again look at small-cap companies, particularly when combined with some exposure to gold as a hedge against renewed downside pressures on stocks.”

Cohen recognizes that the newly enacted government programs could prove helpful in jump-starting the U.S. economy – which should enable the recent upward move in stock prices to continue. In particular, he sees some successes in the Fed’s attempts to get corporations and municipalities borrowing again.

“The credit markets definitely are showing signs of life,” said Cohen. “In the first quarter, domestic companies issued over \$350 billion in new investment-grade paper and interest rate spreads between [corporate bonds] and Treasuries are coming down. Likewise, according to Lipper, investment-grade [municipal bonds] were up 4% to 5% in the first quarter and investor demand for such offerings seems to be on the rise. In fact, the state of California moved up a recent sale of \$4 billion in bonds by a day to accommodate the demand for what turned out to be one of the largest tax-exempt offerings since 2007.”

**Mortgage-market distress** could also create some investment opportunities for investors who do their homework, Cohen says.

“I am a firm believer that challenges create opportunities, and no products have experienced more significant challenges over the past few years than mortgage-related securities,” said Cohen. “Amid the subprime debacle and related credit crisis, all mortgage products have struggled and even the higher-quality paper is being priced as if it is a toxic asset. We use a fixed-income manager who has been buying up more stable mortgage-backed issues at what he perceives to be tremendous values because of the negativity that has enveloped the entire asset class.”

A market historian to the end, Cohen likes to return to what he knows best when attempting to

analyze just where he believes the markets will head next.

“Dating back to 2000 through mid-March, the equity market lost about 3% in value, so history may suggest we are about halfway through what some would call a secular bear market,” Cohen said. “During such times, it is quite common to experience periods when markets really take off. In fact, during the last few weeks in March, equities rose over 20% and some investors have pointed to that move as evidence that the market had bottomed and the turnaround had begun. In reality, since October 2007, we have seen six rallies of various magnitudes.”

### Related Links:

**Money Morning Market Analysis:** [Will the Dark Cloud of Commercial Real Estate Blot Out the U.S. Recovery?](#)

**Money Map Press:** [The “Super Crash” May Soon Devastate Millions Of Americans... Others Will Get 5 Times Richer](#)

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