



Our 2009 Forecast for the Economy and the Markets

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An important goal for Advisor Perspectives is the collection and analysis of independent research about the economy and the markets. As we enter what promises to be a very challenging year for advisors, we are taking this opportunity to synthesize that research into a coherent forecast for the markets. We then translate this forecast into our recommended asset allocation.

Independence is a key criterion when we assess the reliability of analysts' forecasts. We are skeptical of forecasts from analysts and economists who represent investment firms, whose views can be tempered by the interests of the firms they represent. Our second guiding criterion is accuracy. We have selected individuals with proven track records of accurate predictions. Moreover, their predictions were backed by the data-driven analytical approach which we support. They were right for the right reasons.

The analysts whose forecasts we used are the following:

- Nouriel Roubini – Roubini, a professor of Finance at NYU and founder of the web site [RGE Monitor](#), emerged from obscurity when, beginning in 2006, he predicted the collapse of the housing market and the subsequent credit crisis. His pessimism earned him the nickname Dr. Doom, but his forecasts have been extremely accurate, and they have been accurate for the right reasons.
- John Mauldin – Mauldin is a consultant, author, investment advisor, and runs the web site [Front Line Thoughts](#). He correctly forecast the housing crisis and many of the subsequent problems in the financial markets. His 2008 forecast for the economy and US equities markets was optimistic, but we believe his overall track record establishes his credentials as a reliable forecaster.
- Woody Brock – Brock is a consultant and his firm, [Strategic Economic Decisions](#), advises many of the largest hedge funds, private equity funds, and institutional investors. Brock has been warning his clients for many years about the housing markets and the risks in the US equity markets.
- Niall Ferguson – Ferguson is a historian, a professor at the Harvard Business School, and the author of the best selling book *The Ascent of Money*. Like those above, Ferguson saw the problems in the housing markets and the risks to world financial markets years before problems began to escalate.



- Peter Bernstein – Bernstein is a consultant, author, and publisher of the highly-respected newsletter Economics and Portfolio Strategy. In our interview with him on January 29, 2008, he correctly forecast the risks in the market over the ensuing year.
- John Williams – Williams runs the web site [Shadow Government Statistics](#), which critiques government reported data for the CPI index and related statistics. While Williams' forecasts not have proven to be as accurate as those above, we believe understanding and considering his views are essential to properly assess the risks in the market.

In addition to these experts, we incorporate the opinions and analyses of a number of other individuals we have interviewed over the last year.

The Economy

Forecasts for the US economy fall into three broad categories:

1. A 3-4% GDP contraction with the economy turning around in the second half of 2009. The current recession would last approximately 18 months, similar to most post-War recessions.
2. A 5% GDP contraction with a recovery in 2010, making the current recession significantly more severe than any other post-War recession.
3. A contraction greater than 5% with a possible GDP contraction of 10% or more, which would be classified as a depression.

The consensus of the independent analysts we surveyed falls into the second category - a 5% contract with a slow recovery starting in 2010. The forecasts from the broader economic community fall into the first two categories, but a few economists forecast a depression.

Nouriel Roubini forecasts negative GDP growth through the end of 2009, resulting in a cumulative output loss of 5%. He sees a weak (1%-1.5%) recovery in 2010 and 2011. In December of 2008, he said, "The worst is not behind us; 2009 will be a painful year of global recession, deflation and bankruptcies."

In January of this year, John Mauldin forecast that "the US and much of the world are going to see their economies shrink for at least another year. And when that new, lower level is reached, the economy will slowly start to grow again. ... This recession is going to be the longest in anyone's memory."

In November of last year, Woody Brock forecast "a long two-year growth recession with several negative quarters of GDP growth." That will come with "world growth likely falling from almost 4% a year ago to 1%, crippling many US



exporters, with private equity and credit card debt likely to sour, with Detroit imploding, with house prices still falling, and with unemployment now likely to rise to 8% or higher by yearend 2009.”

Niall Ferguson’s forecast in December of 2008 was for “a fairly bleak 2009, with unemployment reaching double-digits and a full year of recession. This is likely to be followed by four years of slow growth as de-leveraging works itself through the economy.”

Ferguson added that “if growth starting in 2010 is only about 1 percent for the next five years, it’s hard to imagine how the US economy can create jobs the way it has in the past. So we can certainly expect average unemployment over the next five years to be significantly higher than what we’ve been used to, something closer to European levels of around 8 percent.”

Supporting the forecasts of these experts are several major factors:

- Housing prices have not stabilized and will not stabilize for at least another year. The Case Shiller housing index must contract another 10% to realign with pre-housing bubble trend lines, and there is no reason why prices will not overshoot and fall by more than 10%. New and existing home inventories remain at historically high levels and this supply/demand imbalance will prevent the housing market from stabilizing. Although government programs should eventually stem foreclosures, in the near term news on the housing market will be uniformly bad, as delinquencies accelerate and defaults increase, with problems spreading from the subprime and Alt-A markets to option ARMs and prime mortgages.
- Although mortgage rates are declining as credit slowly begins to flow in the housing markets, that loosening will be insufficient to bring homebuyers back into the market. Lending standards have tightened, and buyers will wait for signs of market stabilization before re-entering the housing market.
- Stabilizing housing prices is necessary (but not sufficient) to restore consumer confidence. Consumer spending, which represents approximately 70% of GDP, will not grow while housing prices are in decline.
- The de-leveraging of the financial system is between one-half and three-quarters complete. Financial institutions still have many problematic assets on their balance sheets, and they will be written off in the coming quarters. Write-offs may balloon as unemployment rates rise and consumer debt becomes more vulnerable. Although banks have tightened credit card standards, those moves may not be aggressive enough to



prevent significant consumer defaults. In any case, tightening of consumer lending standards will inhibit consumer spending.

In our September 30, 2008 [article](#), Dean of Harvard Business School Jay Light advocated a medical-style triage approach to the financial trauma: stabilize the patient, fix the problem, and follow through with a rehabilitation and recovery process. We are still attempting to stabilize the patient, which means any suggestion of a quick economic recovery is premature.

Other experts have forecast outcomes both more extreme and more optimistic than ours.

John Williams' forecast is representative of those who believe a depression is likely. Williams' thesis, as explained in our [interview](#) with him on May 6, 2008, is that the US government is bankrupt, considering the size of existing deficits and the unfunded liabilities of government entitlement programs. The size of the projected stimulus plans underscores his points. Eventually, foreign governments will stop lending to the US (through their purchases of US Treasury securities) and interest rates will rise. Once that happens — within the next year, he now fears — the economy will be in a hyperinflationary depression.

Williams' forecast cannot be dismissed. A non-zero probability exists that the scenario he projects will unfold. The consequences would be extreme, and must be considered in any investor asset allocation.

At the other extreme, our interviews with a number of prominent and respected economists and analysts reflect forecasts that fall into the first category above. (See, for example, our interview with [Brian Wesbury](#) on January 13 and the articles covering [Greg Valliere](#) and [Mark Chandler](#) in this issue.) Just as we cannot dismiss John Williams' forecast, we cannot dismiss these more optimistic forecasts (and we assign them a much higher probability than Williams'). But these forecasts share an overly optimistic belief that consumer spending can be restored, either through easier credit or through the projected government stimulus. We believe the deteriorating housing market, continued de-leveraging, rising unemployment, and tighter consumer credit will overwhelm those factors, combining to inhibit consumer spending.



The Markets

We believe the US equity market is overvalued, but very attractive returns are available in the fixed income markets (other than the US Treasury bond markets). This belief was articulated in our November 18, 2008 article, [The Disappearance of the Equity Risk Premium](#). Fixed income spreads have contracted modestly since that article was written, but the basic thesis remains valid: spreads throughout the fixed income markets, particularly in the investment-grade corporate bond market, are at historically high levels and offer far more attractive returns (on a risk-adjusted basis) than do US equities.

Our views are supported by a number of independent analysts.

Price/earnings ratios, when normalized using a rolling 10-year average of historical earnings, are not at the levels where bull markets typically start. (See this [article](#) for an explanation.) This methodology was originally advocated by Graham and Dodd, and it has recently been popularized by Yale professor and economist Robert Shiller. By his standards, P/E ratios are currently approximately 20, versus an average of 18.3 over the last 100 years. Bull markets typically start with P/E ratios below 13.

Peter Bernstein supports this view. On November 13, 2008 he wrote, "Under these circumstances, and regardless of when the black clouds on the horizon finally begin to brighten, we would put low odds on a renewed bull market with ebullient price/earnings ratios and declining dividend yields. For a long time into the future, equity returns are likely to be muted."

"I think we could see a tradable rally in the next few months, but at the very least test the lows this summer, if not set new lows," said John Mauldin. "Earnings are going to be far worse than any analyst's projections I have seen. And earnings drive stock prices."

On December 11, 2008, Woody Brock expressed a similar view. "2009 will be a very bad year for the US and global economy, and we stick to our belief that preserving capital is the only strategy to consider for the next six months, and probably more," he said. "In particular, avoid widespread nonsense about the US stock market 'finally being properly valued.' The risk is that it will go much lower."

PIMCO co-CEO and co-CIO Mohammed El-Erian, on December 9, 2008, warned that "investors should not automatically rebalance portfolios, because doing so implies increasing allocations to equities." He believes there are better opportunities in other asset classes.



On January 9, 2009, Nouriel Roubini said that “considering the likely economic stagnation ahead, bonds should be a better bet than equities for some time. We see meaningful downside risks to stock prices as bad macro news – worse than expected – continues to dominate in 2009.”

Many disagree with our view of the overvaluation in the equity markets. On November 18, 2008, Wharton professor [Jeremy Siegel](#) explained why he believes US equities were “dirt cheap.” (For a rebuttal to Siegel’s arguments, see [here](#).) On December 2, 2008 we reviewed a [DCF model](#) that suggested the market was 20% undervalued. (DCF models are notoriously sensitive to the choice of discount rate.) A [survey](#) of Wall Street sell-side analysts revealed a consensus forecast of a 16.9% return for the S&P 500 for 2009. (But those same analysts’ 2008 [forecasts](#) were wildly optimistic.) Most notably, on October 16 2008, Warren Buffett said to “Buy American” in a [New York Times Op-ed piece](#).

Those looking for a reason to invest in equities will find no shortage of support for their beliefs. Nonetheless, we remain convinced that the returns offered in the US fixed income markets remain far more attractive.

Asset Allocation

We believe a conservative allocation is essential for 2009, as dictated by deteriorating worldwide economic conditions and negative investor psychology. While record amounts of cash are in money market accounts, investors must overcome the psychological hurdle of a decade of near-zero returns in the US equity markets before reinvesting these funds. As Woody Brock has said, “Investors are rightly disenchanted with the fact that stocks have lost them money over the past decade. There is nothing like growing disenchantment with past returns to drive valuations lower.”

We recommend four asset classes:

- Treasury Inflation Protected Securities (TIPS)
- Mortgage Backed Securities
- Investment Grade Corporate Bonds
- Actively managed US equities with a value-oriented approach

Yields on TIPS now reflect a break-even rate on inflation of less than 50 basis points over the next 10 years. Inflation must average less than .5% over this ten year period for TIPS to be inferior to fixed-rate Treasuries, a highly unlikely scenario. Although deflation may persist in the short term, huge government deficits will surely lead to inflation. TIPS offer excellent returns in an inflationary environment, and they offer a reasonable hedge against John Williams’ forecast



of hyperinflation (although, if you fully accept Williams' forecast, the only safe asset is gold).

Mortgage-backed securities, backed by the US government, offer yields of 4%-6%. The challenge in this market is that the government is buying some of these securities, driving up prices. The best approach to this market is through a mutual fund or other professionally managed account.

Our case for investment grade bonds was stated in our November 18 article noted above, and that case was echoed by Loomis Sayles' bond manager Dan Fuss in the December 2, 2008 article, [The 50-Year Opportunity in Bonds](#).

Vanguard founder John Bogle, in our [interview](#) on December 23, 2008, said "I expect equity investors will realize 8-10% returns over the next decade." Returns approaching these levels are still available in the investment grade bond markets with 10-year maturities, reinforcing our belief that broad-based equity exposure is unjustified in the current markets.

We believe the upheaval and forced selling in the US equities markets creates the exact environment where talented value-oriented managers will thrive. We interviewed one such manager ([Bruce Berkowitz](#) on January 6, 2009) who said that the opportunities for the types of companies he likes to buy were better than at any time since 1974. Such exposure to US equity markets may take more than one year to pay off, but it offers a good hedge against the possibility that we are wrong in calling US equity markets still overvalued.

For taxable accounts, attractive values remain in the municipal markets. But many state and local governments are under significant financial stress, and careful credit analysis is essential in these markets. We would avoid all high-yield municipals (as we would avoid high-yield corporate bonds).

The worldwide recession means non-US equity markets are unlikely to offer significantly more attractive returns over the next year, and will likely exhibit more volatility. Our conservative bias for 2009 argues for equity positions concentrated in the US markets.

We believe private equity and venture capital returns will be depressed in coming years. Private equity will suffer because of its reliance on leverage, and venture capital will suffer because smaller companies will find few opportunities for growth in a risk-averse environment.

REIT returns will suffer as conditions in the commercial real estate market deteriorate and funds experience difficulty rolling over debt financing.



Oil is undervalued. Once the economy returns to full capacity – which may take several years – oil will return to levels approaching its previous highs (\$140/barrel). We believe oil prices are governed by supply and demand (see our article [Oil Prices in the Era of Thugocracy](#)) and not by speculator manipulation. Our view is predicated on a belief in the theory of peak oil; those not ascribing to this belief will have a different forecast for oil prices.

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