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V, U, W OR L SHAPED?

The recession of 2008-09 has now stretched into its 17th month in the US, if one accepts the National Bureau of Economic Research (NBER) dating of its inception in December 2007. This makes it the longest since World War II, and the back to back contraction of more than 6% in US Gross Domestic Product (GDP) in Q4 2008 and Q1 2009 are the deepest in 50 years, since the Eisenhower recession of 1957-58. In Canada, the economy is forecast by CIBC World Markets to have contracted 7.3% in Q1 2009. Q2 GDP is forecast to shrink 2.4% in Canada and 3.2% in the US, real consumption growth to shrink 1.7% in the latter and only grow 0.5% in Canada (and remember that the consumer is 70% of GDP in both countries) and CPI inflation set to fall to 0.4% this year in Canada and go -0.8% negative in the US. Unemployment, meanwhile, is set to rise steadily through this year and next, reaching 9% in Canada and almost 10% in the US by the end of 2010 (all forecasts from CIBC World Markets).

Given this tale of gloom and despondency, why on earth, investors may be asking, are the S&P/TSX and S&P500 indices up 35% from their lows reached at the beginning of March? Surely, the stock markets are supposed to represent the underlying fundamentals of the economy and companies, with earnings, despite beating analysts' bearish estimates for Q1, down more than 30% from a year earlier, and that after a 70% decline in Q4. Provisions for bad loans have continued to rise for both US and Canadian banks, offsetting much of the benefits they are deriving from the ultra low interest rates of 0-0.25% that the US Federal Reserve and the Bank of Canada have mandated, while ballooning government budget deficits are starting to be recognized by government bond markets, with the yield of longer dated US Treasury bonds such as 10 and 30 year issues now 1% higher than they were at the beginning of the year and up over 0.75% since the Fed announced in mid March that it would buy U$300bn of long dated bonds to keep interest rates (and hence mortgage rates which are based on them in the US) at a low level.

Once again the markets are demonstrating that they are capable of anticipating and discounting developments in the underlying economies and companies. Just as US markets peaked in October 2007, a year before the full seriousness of the credit crisis became apparent in the real world, so many observers believe that markets have now discounted the worst effects that the crisis has wreaked on the real economy and are beginning to look beyond this year's bad news and expect a recovery in 2010. CIBC World Markets has GDP falling 2.7% in Canada and 3.2% in the US this year, the worst year since at least 1982, but growing 1.5% and 1.8% respectively next year, even though unemployment keeps rising. This is due to the tendency of unemployment to be a lagging indicator, which is what a moment's reflection would lead one to expect. Employers are reluctant to let go of experienced and trained workers, especially in fields such as technology, resources and manufacturing, where there are often shortages of suitably qualified personnel. Initially, they will reduce and then eliminate overtime, stop employing temporary workers, cut costs such as travel, entertainment and corporate spending, and then finally start letting go the least productive members of staff. Thus unemployment will not begin rising until well after the beginning of a recession, in the case of the US, in mid 2008 when it had begun at the end of the previous year.

Likewise, when conditions begin to improve, employers will be reluctant to start hiring fulltime staff too early, as there may be false dawns which reflect nothing more than restocking by customers who have run their inventories down to unsustainably low levels, and will initially increase overtime (which is why productivity always grows rapidly coming out of recessions), then hire temporary staff, and finally begin hiring a portion of the fulltime staff they really need. In the same way as the stock market is a leading indicator, and indeed is included in the 10 different items that are included in governments' Index of Leading Economic Indicators, beginning falling or rising 6 months ahead of bear markets and bull markets, as the increase in liquidity caused by central banks starts flowing initially not into the real economy but into liquid assets such as bonds, stocks and other financial instruments, so unemployment is a recognized lagging indicators which does not stop rising for up to a year after the official end of a recession.

The real question at the moment is what sort of recovery North America will experience, and whether it will be a traditional sharp V shaped recovery, with the economy snapping back rapidly, especially given the severity of the present recession or whether it will resemble one of the other letters of the alphabet at the beginning of this article, a U, L or W shaped recession.