

SOME FACTS ABOUT RECESSIONS AND MARKETS

Investors face a challenging economic environment. High frequency statistics are providing contradictory signals often only a few days apart. With talk of a recession in the U.S. intensifying, this week's edition of the Marker considers the facts surrounding the historical record of market performance under various recessionary scenarios.

DEFINITION REQUIRED

From an academic standpoint, recessions are truly odd creatures. While their impacts are obvious and often painful in real life, their very existence is determined after the fact by a committee of the National Bureau of Economic Research (NBER). The official definition of a recession also varies. In the U.S., a recession is defined as "a significant decline in economic activity spread across the economy", while in Canada it refers to two consecutive quarters of negative GDP growth. Note that in conformity with this definition, the U.S. economy actually grew during the 2001 recession.

U.S. RECESSION: ONLY A POSSIBILITY AT THIS STAGE

Investors and markets of course do not wait for a committee to declare the start and end dates of recessions. Equity markets are famed discounting mechanisms that tend to react well ahead of actual slowdowns. Market trends since the fall demonstrate how equity investors have become increasingly worried about a slowdown/recession in the U.S., and the impact it may have on the global economy. A recent poll indicates that two out of three Americans felt the U.S. was in a recession or would likely experience one in 2008. We must remind ourselves that fourth quarter GDP growth in the U.S. was a positive 0.6%. Monetary and fiscal policies in the U.S. have been modified aggressively to mitigate the risks of a deep recession. Yet, economic releases point in opposing directions from one week to the next. Given this level of confusion, observers have chosen to assume the worse, and focus on the dark side. We cannot ignore the fact that most forecasting models point to a slowdown as the likely scenario, and assign probabilities of recession in the 30 - 45% range. We need to keep in mind the U.S. has experienced three recessions since 1982, while the UK has not had one in 15 years.

MARKET REACTION

We rely on work from Merrill Lynch¹ and consider the historical record to assess how equity markets react to recessionary environments. The U.S. has experienced 10 recessions since World War II. On average, each of them lasted 10 months (a range of 6 to 16). Typically, the S&P Index peaked three to six months before the start of a recession, and experienced a 20% pullback from prior peak to end. The market tends to also discount the recovery by hitting its low before the end of a recession (see chart). The issue of whether or not the U.S. economy is or will enter into a recession in 2008 has yet to be decided. Market action over the past several weeks is consistent with expectations that a recession is likely. A significant part of such a retrenchment has already taken place; investors must be aware of the historical record to adequately assess the appropriate course of action going forward.



Source: Merrill Lynch

NATCAN WEEKLY MARKER

Recession signposts - like the groundhog announcing the end of winter - are difficult to spot and interpret correctly. While the debate surrounding the U.S. economy rages on, markets act as if one had already taken hold. Investors need to be aware of the historical record surrounding previous U.S. recessions. A move to an extremely defensive positioning of a portfolio could prove very costly at this stage. Adhering to a well thought-out strategic allocation while making sure one is positioned for the inevitable discounting of the recovery appears to be the best policy.

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FINANCIAL MARKETS

RETURNS AS AT FEBRUARY 8, 2008 (%)	MTD	QTD	YTD
S&P/TSX	-1.23	-5.89	-5.89
S&P 500	-3.74	-8.61	-8.61
S&P/TSX Small Cap	0.30	-6.52	-6.52
Russell 2000	-2.38	-8.14	-8.14
MSCI EAFE	-5.06	-11.97	-11.97
MSCI World	-4.55	-9.94	-9.94
DEX Universe Bond	0.32	0.94	0.94

	RATES AS AT FEBRUARY 8, 2008
CAD/USD	1.00
CAD/Euro	1.45
US Treasuries yield 10-yr/30-yr	3.65/4.44
GOC bond yield 10-yr/30-yr	3.83/4.19
Fed Fund Rate (target)	3.00

Note: Returns in Canadian dollars, London 4h exchange rates. Source: Datastream, PC Bond, MSCI-Barra, and Bloomberg. PC-Bond, a business unit of TSX Inc. Copyright © TSX Inc. All rights reserved.

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¹ Merrill Lynch Economic Analysis, 28 Jan. 2008