



Weekly Market Commentary



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The Markets' Recession Obsession

Jeffrey Kleintop, CFA

Chief Market Strategist
LPL Financial

Highlights

Investors may not need to worry about the impact of a recession since it already appears to be fully priced in to both stocks and bonds.

This is not unusual. Historically, the stock market has often bottomed before the recession was even declared. And, importantly, there have been times when the stock market fell and priced in a recession that did not take place, such as the bear markets of 1987 and 1998.

Based on our analysis of past earnings cycles, a recession level for the S&P 500 Index is about 1120, which is exactly where the Index bottomed out three times during the month of August.

On Friday, the Labor Department said U.S. payrolls were unchanged last month. This was the weakest reading since September 2010 and worse than economists' forecasts. The weak reading on jobs weighed on stocks as market participants reacted to fears of a recession. The stock market's sharp 2.5% decline on Friday left the S&P 500 down -0.2% for the week, making last week the fifth of the past six weeks that the stock market suffered a loss.

We continue to believe that, rather than recession, weak economic growth will continue this year. However, in recent weeks, markets have moved to fully price in an impending recession.

- Treasury yields have returned to recession levels. In fact, they are below the levels reached in the depths of the last recession (2007–2009) as investors believe the economy will shrink.
- Corporate high-yield bond spreads have widened out to levels seen, on average, in past recessions. Investors expect a recession to reduce corporate earnings and the ability of corporations to make interest and principal payments.
- While stocks remain well above the depths reached during the last recession, a return to recession has been fully priced into the stock market this year during the recent lows based on earnings and valuations.

1 Historical Earnings Cycles for S&P 500 Companies

Cycle Peak	EPS Peak	EPS Trough	Annualized EPS Growth Peak-to-Peak	EPS Peak to Trough Decline	Trailing PE at EPS trough
3Q 1937	1.22				
4Q 1950	2.84	2.34	6.6%	-18%	7.2
3Q 1956	3.69	2.88	5.1%	-22%	13.1
3Q 1959	3.43	3.03	-2.2%	-12%	16.6
3Q 1969	5.89	5.13	5.6%	-13%	15.8
3Q 1974	9.11	7.76	9.1%	-15%	7.0
4Q 1981	15.36	12.43	7.5%	-19%	8.0
2Q 1989	25.91	19.63	7.2%	-24%	12.3
3Q 2000	56.89	44.32	7.2%	-22%	25.9
2Q 2007	91.76	50.84	7.3%	-45%	14.3
3Q 2011	95.28				

Source: LPL Financial, Thomson Financial, Bloomberg data as of 09/02/11



An analysis of the S&P 500 earnings cycles presented in [Table 1](#) reveals that, typically, earnings grow for 5–10 years averaging about 7% a year from the prior peak before they pullback. During a recession they typically fall about 12–24%. The only exception to this 12–24% range was in 2008 when the companies in the Financials sector, the largest sector by earnings at the time, were forced to write off a decade of profits in just one quarter.

We believe it is possible that if the economy deteriorates further and we entered a recession, earnings may fall 12% from current levels. This 12% pullback is at the smaller end of the historical range for several reasons.

- First, we have not had the buildup of corporate debt levels that typically acts as leverage and boosts earnings in the later years of a business cycle. That leverage later comes out in just a few quarters and acts as a multiplier on the earnings pullback. Instead, the opposite has taken place this time, as corporations have continued to reduce debt after the downturn ended, leaving much less than usual downside to earnings in a recession.
- Second, unlike past cycles, the S&P 500 now gets 25% of sales from fast growing emerging markets relatively unaffected by a recession in the developed markets. That growth will continue for the most part regardless of the U.S. economic backdrop. This is one of the key reasons profits have boomed at a double-digit pace despite the very sluggish economic growth in the United States in the first and second quarter of this year.
- Third, businesses have not done a lot of hiring yet this business cycle. The vast majority of corporate costs are labor. Businesses have not reached the point where a pullback in demand from a recession would result in them being suddenly overstaffed and have to suffer big costs associated with early retirement, mass layoffs, or retaining excess workers as demand falls.
- Fourth, we have barely started to grow earnings above the prior peak. In general, earnings pullbacks are proportional to the gain they achieved during the cycle. The below-average earnings gain is likely to result in a below-average pullback. For example, back in 1959, the earnings cycle was short and earnings pulled back without growing above the prior peak. During that correction earnings fell just 12%.

If a recession develops and earnings fall 12%, the total earnings per share (EPS) of the past four quarters, which now stands at a little over \$95 for S&P 500 companies, would fall to about \$83.85. This would return EPS to a level first achieved over five years ago.

Historically, the trailing price-to-earnings (PE) ratio for the S&P 500 averaged 13.35 at the recession-driven earnings trough. Some periods were much lower and occurred during periods of double-digit inflation in the late 1970s and early 1980s. Others periods were much higher for various reasons, including the lingering tech bubble mania in the early 2000s.

If we assume recession EPS of \$83.85 and multiply that by the average recession PE of 13.35, we get a recession level of about 1120 for the S&P 500, which is exactly where it bottomed out three times during the past month.



It is no wonder that during August the stock market fully priced in a recession as events took place that included:

- The debt-ceiling debacle
- U.S. credit rating downgrade
- Worsening European debt problems
- Riots in London
- The worst month for U.S. casualties in Afghanistan
- Plunging consumer confidence readings

All of these combined to drive the stock market down 18% from the peak that took place back in April of this year.

Investors may not need to worry about the impact of a recession since it already appears to be fully priced in to both stocks and bonds. It is not unusual for the stock market to fully price in a recession well before it has ended or even before it has been declared. Over the past 50 years, the stock market has typically bottomed three to six months before the low point of the recession. In addition, there have been times when the stock market fell and priced in a recession that did not take place, such as the bear markets of 1987 and 1998. It seems that the debate over whether a recession will take place has now been settled for many investors and they have moved on to whether the recession will be much worse than average.

Based on this analysis, a much worse-than-average recession could drive EPS down 22% to \$74.32. In that event, the S&P 500 Index may suffer a greater decline to about 1000, which would mark a peak-to-trough market decline of a hefty 36% from the recent high of 1363. We see this as a very low probability. Despite the worries over the weak August job report, it is important to remember that just one month ago (the July 2011 report released in early August) the jobs report was much stronger than expected. As we have been saying all year, volatility in the economic data is to be expected. While sentiment readings were weak, economic data during the month of August was positive, solid, and pointed to continued slow growth. These key reports included: industrial production, retail sales, durable goods orders, shipping traffic, business lending, initial jobless claims, corporate earnings reports, and both the manufacturing and non-manufacturing ISM indices.

We see more upside than downside to the stock market. Our base case remains, as it has all year, for stocks to post modest, single-digit gains in 2011 which suggests about a 15% gain from current levels. A recession, the odds of which we peg at about a 1-in-3 chance of taking place, may mean that stocks revert back to the August lows of 1120 and suffer a 5% decline from the closing level on Friday, September 2. And we see a very low, but not zero, probability of a deep recession that may pull stocks down another 15% from current levels.

The markets' obsession with recession does not make it a foregone conclusion. Investors' lack of confidence in economic growth, corporate profit forecasts, and the actions of policymakers is likely already fully



reflected in the markets and creates the potential for a bounce if any of them exceed low expectations. Like we said as the market made the lows of August: the stock market climbs a wall of worry not when risks go away, but when the confidence that they will be overcome returns.

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The P/E ratio (price-to-earnings ratio) is a measure of the price paid for a share relative to the annual net income or profit earned by the firm per share. It is a financial ratio used for valuation: a higher P/E ratio means that investors are paying more for each unit of net income, so the stock is more expensive compared to one with lower P/E ratio.

Earnings per share (EPS) is the portion of a company's profit allocated to each outstanding share of common stock. EPS serves as an indicator of a company's profitability. Earnings per share is generally considered to be the single most important variable in determining a share's price. It is also a major component used to calculate the price-to-earnings valuation ratio.

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