Investors betting economy follows them into recovery

Market is up 50 percent from the worst, but fears of relapse remain

By Adam Shell
USA TODAY

NEW YORK — As all burned investors now know, an economy mired in a deep recession acts like a powerful depressant on the stock market.

But there is an antidepressant with the power to fix this financial mood disorder: an economy showing signs of recovery.

The transition from recession to recovery has historically been a good time to own stocks, as the prospect of better days ahead gives investors a reason to buy. Big rallies occur even though many economic worries still persist, the buying is built largely on hope, and skeptics loudly proclaim that the gains can't last.

The broad U.S. stock market's quick and powerful 50 percent rally since hitting a 12-year low in early March is proof that this market phenomenon remains in vogue.

"In the beginning of bull markets, investors focus on faith more than fundamentals, sounding more like (evangelist) Billy Graham than (famed value investor) Benjamin Graham," explains Sam Stovall, chief investment strategist at Standard & Poor's.

But that faith has been tested in recent days — leading many investors to wonder if it's too late to get in. The latest readings on consumer confidence, retail sales and profits at home-improvement retailer Lowe's came in weak, reminding investors that consumers — a key driver to a sustainable recovery — are still not in a spending mood as the fallout of the worst recession since the 1930s drags on.

A two-day stock decline of 3.3 percent before Tuesday's 1.0 percent rebound increased calls for a pullback from analysts who say stocks have shot up too far, too fast, given the still-weak business environment.

Still, buying stocks on faith, while not risk-free, is not altogether irrational, since stock prices are built on the future, not the past. The stock market is viewed as an economic forecasting tool. Since 1984, the market has been right 80 percent of the time in calling the economy, Ned Davis Research says. Investors hope stocks have correctly called the end of this recession.

"Investors are anticipators," adds Stovall. "They can't wait for the data to confirm their assumptions (that the economy is getting better), because they are competing with millions of investors around the globe. They want to get in before the others."

But even Stovall won't rule out a pullback in the short term as mixed economic data raise questions about the strength and staying power of the recovery. The biggest stock dip so far has been a 7 percent swoon from mid-June to mid-July.

It often pays to invest when the financial system and economy appear on the verge of collapse and stocks are selling cheaply — as was the case in March, when even President Obama was warning of the possibility of a depression.

"We have found you make more money when you go from horrible to bad than from good to great," says David Darst, chief investment strategist at Morgan Stanley Smith Barney.

History backs up that claim. A Citigroup study shows that stocks start rising in the second half of recessions, gaining 13 percent on average since the early 1950s. Citi data also show that stocks post average gains of roughly 40 percent in the 12 months after a market trough. Stocks also fare well once a recession ends, says Ned Davis Research. Stocks were up sharply one year later in nine of the past 10 recessions.

The sharp rise in stock prices in the past five months fits with the timing of past recoveries. On average, stocks turn up four months prior to the end of a recession and nine months before the peak in unemployment, S&P says.

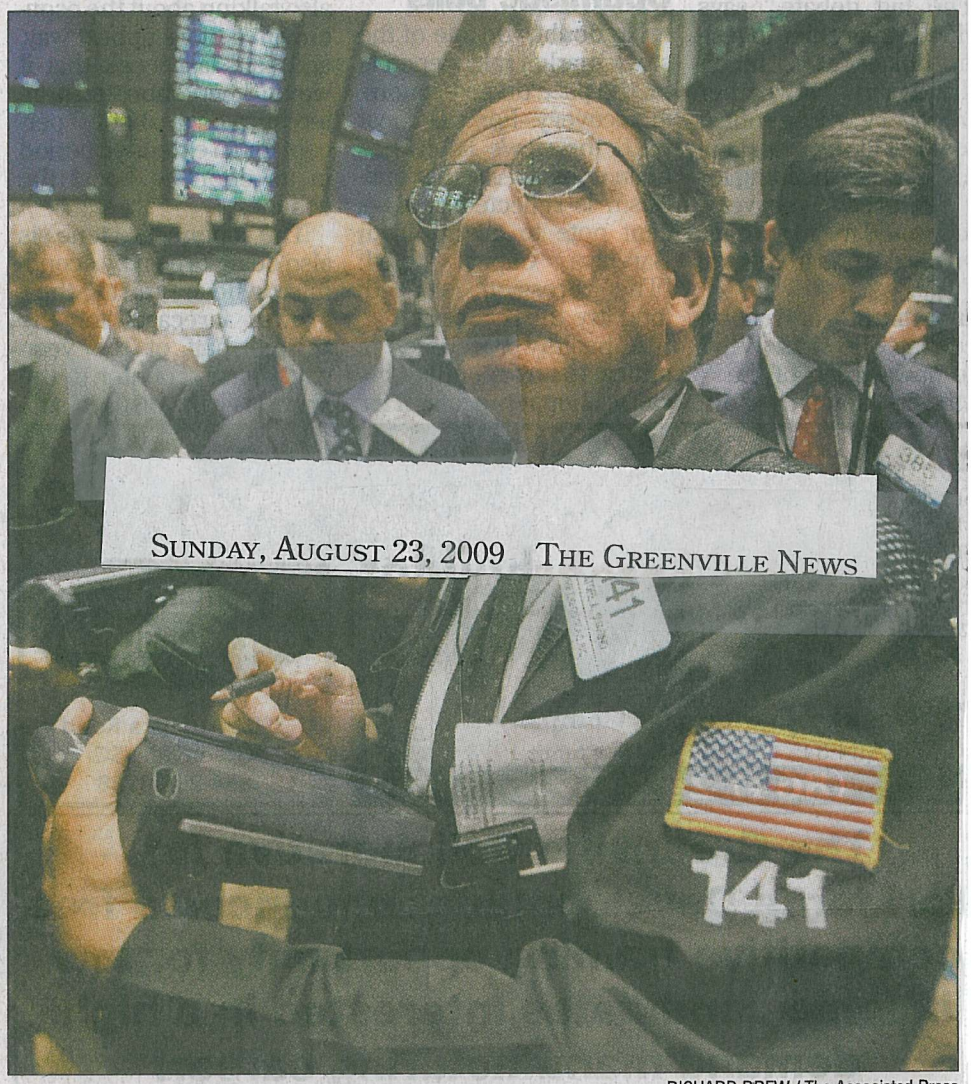
The value of the stock market has risen $3.8 trillion in the rally since March 9, but is still down $7.0 trillion from its Oct. 9, 2007, peak, Wilshire Associates says.

This big rally has rewarded courageous investors who were willing to place bets on stocks prior to concrete signs of a recovery.

But many investors have missed the rebound because they were too afraid to get back in after being burned in the bear market, which knocked the S&P 500 down almost 57 percent. And after a 50 percent rise, many investors still on the sidelines are reluctant to jump in now for fear of getting back in at yet another top.

The dilemma for investors now is whether to bet on an ongoing recovery or to take profits and wait

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RICHARD DREW / The Associated Press

Despite a 50 percent improvement in stock values in recent months, Wall Street remains rife with fears of relapse.

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to see if the rebound is sustainable.

"The big debate," says David Kotok, chief investment officer at Cumberland Advisors, "is whether the recovery will be robust or tepid Will it be sustainable? Or are we heading for a W-shaped recovery, which would mean another downward leg is in front of us?"

Only time will resolve the debate, he says. Why? "The upward leg of the V and the first upward leg of a W both look the same," says Kotok. If it is a W, that means the economy could suffer a double dip, or relapse, which is likely to drag stock prices down sharply.

Optimistic bulls

No doubt, the fate of the stock market rally depends on the pace of the economic recovery. For the most part, the news lately has been upbeat. And that optimism is reflected in a recent note to clients from Barclays Capital titled: "The recession is dead; long live the recovery."

A healthy consumer is critical to any rebound, because shoppers account for roughly two-thirds of economic activity. If people whip out their wallets again, it will force businesses to start replenishing depleted inventories, a further boost to the economy.

The Federal Reserve is also talking about the economy in a more upbeat way, and said last week that it would keep short-term interest rates at about 0 percent for an extended period in an effort to boost the economy.

The optimistic tone is also being driven by economists who are raising their growth forecasts for the second half of the year, which runs counter to the previous consensus of subpar growth in coming quarters. ISI Group, for example, is estimating 4 percent GDP growth in the final six months of the year. The ISI estimate is above the long-term average of 3.4 percent, according to government data. But ISI's estimated growth rate is still shy of the average 7.3 percent growth in the quarter after a recession ends, data from Strategas Research Partners show.

Corporate profits are also improving, with second-quarter reports coming in much better than expected. Analysts expect earnings growth in the fourth quarter, which would end a streak of eight-consecutive quarters of shrinking profits if the current quarter comes in negative as expected, Thomson Reuters says.

Bulls also are betting that the government's $787 billion stimulus program will be a positive story in 2010, since only about 12 percent of the money was spent through July 31, according to Strategas.

Jack Ablin, chief investment officer at Harris Private Bank, says the stimulus package is akin to a "time-release" drug that enters the system slowly.

All that positive momentum has provided ammunition to those who argue that the market's run-up is justified by improving conditions. Carmine Grigoli, chief investment strategist at Mizuho Securities, says just because stocks have shot up so far in so little time doesn't necessarily mean "it is time to head for the exits."

"The party may just be getting started," says Grigoli. He notes that rising investor confidence, coupled with record levels of cash on the sidelines, still-low interest rates and stocks selling at decent prices bodes well for a continuation of the rally. Based on 2010 earnings estimates, the S&P 500's price-to-earnings ratio, or P-E, is now 13.2, below the long-term average of 15, Thomson Reuters says.

Bears don't agree

But there are plenty of bears who say the summer rally will end badly. David Rosenberg, chief strategist at Gluskin Sheff, warns that calling an end to the recession may be premature. In a recent report, he said "the market is early in pricing in a recovery." He noted that it normally takes 18 months for stocks to rally 50 percent from a recession trough.

Longtime bear Richard Suttmeier of ValueEngine.com is blunter in his skepticism. "I don't think there is a recovery." He predicts "calls for an end to the recession by the end of the year will be wrong."

Analysts warn of other risks: a sharp rise in inflation and interest rates, which would hurt the recovery and make it harder for the U.S. to pay off its ballooning debt. Some fear higher taxes needed to fund Obama's legislative initiatives. And the old worries of bank write-offs and more trouble in the housing market still rank high on investors' lists.

"You can come up with scenarios that would argue for secondary slumps in the economy," says Tobias Levkovich, chief U.S. equity strategist at Citigroup. Still, for now, he is sticking with his year-end target of 1000 for the S&P 500 — just 1 percent higher than Tuesday's close.