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Sharp Investing

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War, Recession and the Stock Market

By Daniel R. Sharp, Ph.D.

Reviewing how markets have behaved during past conflicts and recessions allows investors to take positive action during the uncertainty and panic that tends to occur at trying times.

The horrific events of September 11, 2001 have changed the way most Americans view the world. There is no doubt that this was the most significant world event to occur in many years. Even though the events took place on U.S. soil, every country in the world has a stake in how history now unfolds.

In times of great uncertainty financial markets all over the world have a cycle that has repeated in all cases: shock and stabilization. There have been 26 significant world events since WWI, with an average negative shock to U.S. markets of 4.25% within a several week period of the event. War has been more significant, with the six outbreaks of war averaging a negative 12% shock to U.S. markets. Then comes the stabilization; one month after the significant event has occurred, U.S. markets have been at virtually the same levels as before the event. Three months later, U.S. markets are, on average over the 26 events, actually 2.5% *higher,* and six months later U.S. markets have been almost 8% higher than before the event. Again, when just talking about war specifically, the minus 12% initial panic turned to plus 2% within a month, 5% within three months, and six months down the road during a war, U.S. markets have been up 6% over pre-war levels. The current event is right on track so far with the historical averages.

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Building a Portfolio in a Slowing Economy

With the days of 100+ PE stocks now a distant memory, investors are struggling to restructure their long-term portfolios to best fit the new world order. Of course, the new world looks an awful lot like the old world, as it has become very apparent that the internet and technology bubbles were a historical aberration. By studying what has worked during past times of war, recession, and generally more uncertain times, investors can be prepared for the repeating cycle of markets.

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Political events, such as war, presidential resignations, assassinations, etc., have not affected markets long-term as much as economic events have over the past 100 years.

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Economic recessions, inflation, the Arab Oil Embargo, the Asian Financial Crisis, and the real market killer – tightening fiscal policy (i.e. higher interest rates) are much bigger worries than world events as they can affect markets long-term if the outcome is less than optimal.

War and uncertainty caused by world events have always had a short, temporary impact on the market, and there is no reason to think otherwise this time.

However, I do not want to discount the possibility of further terrorist attacks creating a second or third wave of panic – in fact it is fairly likely as none of these historical examples include a war fought on our own soil. But it is not the war or fear itself that could put the market in the doghouse for more than just a couple of weeks of panic selling. It is really the effect the uncertainty has on the consumer, who is responsible for almost 70% of the U.S. economy.

If you take a weakening and slowing economy, as we had on September 10th, and add the shock of the terrible event, you certainly expect that consumers and businesses will minimize their spending as an initial reaction. Longer-term reactions really depend more on unemployment rates, interest rates, and the actual wealth effect from the stock market itself.

We have no inflation. We have no energy crisis. We have no crushing national debt. What we have is a normal cyclical economic contraction after 10 years of strong growth. The chart on the next page shows the three recessions (the vertical bars, R74, R82, R91) over the last 30 years superimposed over the growth of the stock market and the Federal Reserve Discount rate. With the recession in '74 it was energy, in '82 it was inflation. The short '91 recession had neither of these problems and therefore was short and not that painful. The current recession is looking more like a '91 recession rather than earlier recessions where more significant problems compounded the contraction of the economic cycle.

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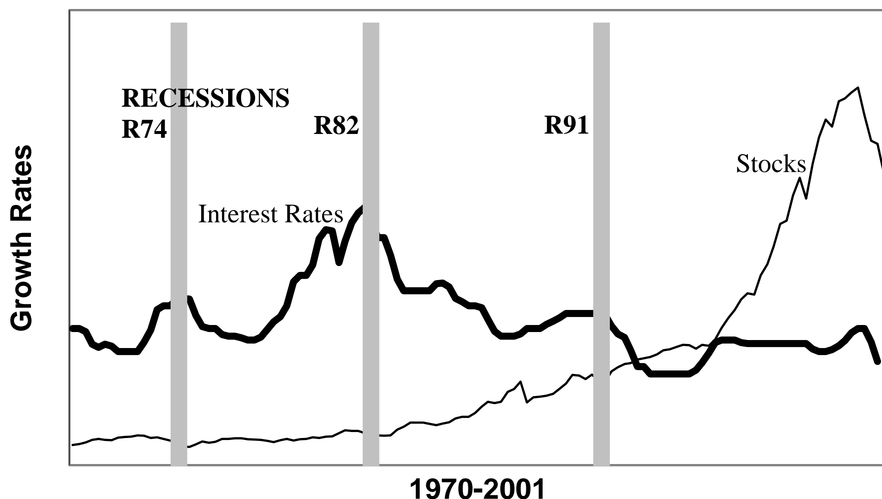
Investing styles run in three to five year cycles. We are only in year two of a strong value cycle. Over long periods of time no strategy has produced better returns than investing in undervalued companies. Learn why and what it can mean for you!

Presented by
Daniel R. Sharp, Ph.D.
Registered Investment Advisor

Stocks, Economic Growth, and Interest Rates



War and Stocks continued from page 2

The chart above shows that the Federal Reserve responds aggressively once they know the economy is contracting by lowering interest rates vigorously. After each recession bar, you can see interest rates move down and stocks move up – no exceptions.

The other aspect to this chart is that stocks decline *prior* to a recession and then generally start a significant recovery even before the economy is technically out of the recession.

War, or further terrorist attacks, or other uncertainties throughout the world, may shock the market short-term, but as long as the Federal Reserve holds down interest rates, and we have no inflationary or energy pressures, the market will climb even as we work through a recession. $

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For several issues, I have been touting the potential of **mid-cap and small-cap stocks**, and indeed they have significantly outperformed the larger stocks now for almost 18 months – yet still remain at 40% lower valuations than the S&P500, i.e. they are still a bargain. The last two issues of *Sharp Investing* www.sharpinvestments.com have more detail on why this asset group will outperform the market in general for the next few years.

Selected segments of the **REIT** (Real Estate Investment Trust) asset group should do very well going forward as the extremely low interest rate environment has made the sometimes double-digit yields of REITs

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Please contact me for an appointment…

- ❑ **…this month**
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Value Investing: The purchase of companies, through the stock market, for less than their economic value due to temporary unpopularity (lack of investor demand). This is the opposite of growth investing, which is buying companies at a premium in the hope that other investors continue to push their prices higher and higher regardless of what the business is actually worth.

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highly attractive. Obviously, segments like lodging or retail real estate are not as attractive as recession-proof areas such as healthcare, self-storage, or even apartment REITs.

For long-term investors, cyclical stocks such as **auto manufacturers, semi-conductors, retail**, and for the truly brave – **transportation,** offer rock bottom prices at the moment. If you believe that the economy will come back in 2002, the time to buy these types of assets is now.

Energy stocks have dipped tremendously because of the fears of reduced demand due to global recession. However, in the long-run demand for energy just keeps growing and growing – and in the short-run energy prices could escalate at any point given the precarious situation in the Middle East.

Low interest rate environments are great for **banks, lenders**, and i**nsurance** companies. Banks with more exposure to mortgage lending have a brighter future right now than those with more exposure to investment services.

If you don't actually already own beaten up **telecom** and **technology** companies, there are bargains aplenty for the patient and careful investor.

Crucial to long-term success is determining both the specific company representations in these various asset classes, and the appropriate mix of these asset classes for each individual investor situation.

However, by concentrating your equity holdings among these groups - smallcap, REITs, cyclicals, energy, financial, and selected technology - you are positioning your portfolio in the sectors that historically have given the best returns for the first five years after an economic slowdown. Non-cyclicals such as healthcare, drugs, food, etc., may preserve capital better in the short-run, but the groups above will outperform over the long-run. $