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The causes of the current severe recession are well known. As stated on March 13, 2009 by Dr. Lawrence Summers, the Director of the White House National Economic Council, former President of Harvard University and former Secretary of the Treasury:

> *"If in the last few years we've seen too much greed and too little fear, too much spending and not enough saving, too much borrowing and not enough worrying, today our problem is very different. It is this transition from an excess of greed to an excess of fear that President Roosevelt had in mind when he famously observed that the only thing we have to fear is fear itself. It is this transition that has happened in the United States today."*

Dr. Summers went on to explain the spontaneous correction of financial excesses and bursting of bubbles, deleveraging in the financial sector and declining asset values all combine to reduce demand and reduce employment. On a global basis, $50 trillion of wealth has been erased in the last 18 months. This includes $7 trillion in U.S. stock market wealth and $6 trillion in U.S. housing wealth. Inevitably, these losses led to a decline in demand with gross domestic product and employment now shrinking at one of the most rapid rates since the Second World War.

How Bad Will the Situation Get?

Regulatory authorities are currently subjecting the 19 largest banks in the United States to "stress tests". The stress tests use two scenarios: a "Baseline Scenario" and an "Adverse Scenario". The Baseline Scenario contemplates -2.0% real gross domestic product in 2009, +2.1% real gross domestic product in 2010 and an 8.8% unemployment rate in 2010. The Adverse Scenario contemplates real gross domestic product of -3.3% in 2009, +0.5% real gross domestic product in 2010, and a 10.3% unemployment rate in 2010. (Some private economists hypothesize the recession will be even deeper than the "Adverse Scenario".)

The Adverse Scenario would be a very severe recession. The two most severe recessions since World War II were in 1974-1975 and the so called "double dip" recession which occurred in the first part of 1980, then resumed in late 1981 and lasted through the first 3 quarters of 1982. In 1975, unemployment reached 8.5% and in 1982 it reached 9.7%.

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How and When Will the Recession End?

In his appearance on *60 minutes* on March 15, 2009 (the first appearance by a Federal Reserve Chairman on a television program in over 20 years), Chairman Bernanke said “we’ll see the recession coming to an end probably this year. We’ll see a recovery beginning next year. And it will pick up steam over time.” Well respected, private economists predict this recession will last approximately 18 to 21 months. As it is believed to have begun at the end of 2007, this prediction would cause it to end in the 3rd quarter of 2009. The average length of the 10 recessions since World War II has been 10.4 months, and depending on how one accounts for the 1980-1982 “double dip” recession, the longest has been approximately 16 months. Of course, the clouds do not dissipate abruptly so the sun immediately begins to shine. The end of a recession is defined as a resumption of growth in gross domestic product. However, as alluded to above, unemployment does not peak until well after a recession ends.

The deeper a recession; the more dramatic the snap back in the economy. This is because:

1. As a recession progresses, individuals do not replace items ranging from sheets and towels to automobiles. Unsatisfied consumer demand becomes very large.* Once the consumer begins to feel a little better, the snap back effect can be dramatic. It begins with the consumer splurging a little on a restaurant meal. It progresses to the replacement of housewares. Ultimately, it leads to the replacement of expensive durable items like automobiles.

2. Likewise, corporations postpone purchases of capital equipment. The demand for capital equipment thus builds up, and as the recession eases, capital equipment purchases accelerate.

3. As part of the slackening of consumer and corporate demand, inventories are allowed to diminish. Once demand shows signs of increasing, inventories must be replenished. This will be particularly dramatic in the current recession because, unlike in so called “classic recessions”, this recession did not begin with a correction of excess business inventories. Inventories were lean when the recession began.

4. The other side of high unemployment is that corporations themselves become more lean and efficient. As demand picks up, so does productivity. Lean, efficient businesses make more productive use of their capital equipment and thus corporate profits increase rapidly.

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* Automobiles provide one of the best examples. Automobile demand in the U.S. is typically about 14 million new cars a year. At the current time, demand is approximately 9 million new cars a year.

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Are Common Stocks Now Undervalued?

The stock market correction accompanying the 1973-1974 recession caused a decline of 48% in the Standard & Poor’s 500. At its lowest point to date, this stock market correction caused a 56% decline in the Standard & Poor’s 500.

The most striking description of the current undervaluation of common stocks was given by Dr. Lawrence Summers in his address of March 13, 2009. He pointed out in early March 2009 the Dow Jones Industrial Average, adjusting for inflation, was at the same level as it was in 1966.

One only needs to set one’s imagination free to remember the vast difference between 1966 and the current time. The microchip had not yet been invented. A computer which currently sits in someone’s lap took up a large, specially designed and cooled room. There was certainly no contemplation of accessing the internet on a cellular telephone as there was no internet and there were no cellular telephones. There was no flexible manufacturing, and there was no “just in time” inventory system. There was no software industry. The workforce was half as large as it is today. The aggregate value of capital equipment in the United States was 1/3 as large as it is today.

As Dr. Summers pointed out:

> This situation . . . “will be regarded by some as suggesting the presence of the sale of the century. For policymakers, it suggests the magnitude of the gains from restoring confidence and sustained economic growth.” (emphasis added)

A Word of Warning

In 1972, the stock market began to rise approximately 2/3 of the way through the recession. In 1982, it began to rise approximately 3/4 of the way through the recession. If we are now in that range, any reasonably sustained stock market advance may be an indication this process is beginning.

Scary headlines will continue long after the beginning of a new advance in the stock market and even after the technical end of the recession. Furthermore, there are always possibilities lurking in the background which can cause a major setback.

The March 27, 2009 edition of the *Wall Street Journal* carried the headline “Bears Are Wary as Bull Returns”. The headline referred to the fact that the popular stock market averages had risen more than 20% in the 13 days following March 9th’s twelve year low.

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This rapid advance may, or may not, mean a new sustained rise in common stock prices has begun. No one knows.

However, we do know the rise in common stock prices after a period of undervaluation caused by a severe recession can be very rapid. Nine months after the 1974 recession low, the Standard & Poor's 500 average had gained 52%. Nine months after the 1982 recession low, the Standard & Poor's 500 average was 61% higher.

What Causes the Rise in Common Stock Prices Despite Disconcerting News?

The advance in the stock market is caused by three fundamental factors:

A. Common stock investors anticipate the snap back in business activity following the recession.

B. The recession produces extremely low interest rates which make the cash flows produced by common stocks, even in a depressed economy, very valuable. For example, the yield on 3 month United States Treasury Bills is currently approximately 2/10 of 1% and the yield on the 10 year United States Treasury Bond has fallen as low as 2.5%. Many common stocks with no significant likelihood of having an impairment of their dividend are yielding more than 4%. In fact, for the first time since the mid 1950s, the dividend yield on the stocks in the Standard & Poor's 500 average is higher than the yield on the 10 year United States Treasury Bond.

C. As the market averages begin to rise, investors begin to switch large amounts of capital from their very low yield cash horde, which recently reached $9.3 trillion (or 84% of the aggregate value of the publicly traded U.S. stock market), to common stocks.

Since 1946, the Standard & Poor's 500 average has risen an average of 176% in the economic expansion following a recession. Not surprisingly, the independent, subscription only *Value Line Investment Survey*, which utilizes a database covering the period since 1920, was hypothesizing in early March 2009 that its average of 1700 common stocks possessed a 3 to 5 year appreciation potential of 175% to 185% ($100 would become $275 or $285).

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