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Recipe for 2009: Add a Pinch of Optimism to That Eggnog

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To describe the past year as a tough one for investors is to state the obvious. At its lows in late October, the Dow Jones Industrial Average[1] had fallen 43 percent from the start of the year. The more broadly based S&P 500® Index[2] had fallen 48 percent. Forecasts of a financial "meltdown" and another "great depression" appeared with greater and greater frequency in the business and general media and in many investment newsletters as well. But while the situation is certainly serious and while risks abound, the probabilities suggest something less alarming and far less dire than these increasingly common forecasts.

The outlook clearly turns on the ultimate resolution of today's financial strains. At the moment, the situation does indeed look bleak. But it would be a mistake to extrapolate the future from current market signals—which surely have lost touch with reality. Take, for example, the subprime debt that lies at the root of today's fears. Currently, a portfolio of bonds backed by such debt sells at 20–25 cents on a dollar of face value. Unless 75–80 percent of these mortgages fail, which is hardly likely, since only one-third of such mortgage debt has problems, reality would call for an upward revision of pricing and with it a less bleak picture. When financial markets again recapture such underlying fundamentals, as they always do, the picture will then look less ominous.

Neither are today's popular forecasts of a great depression especially plausible. For one, this country has deposit insurance, which it did not in the 1930s. Indeed, such insurance has recently expanded to cover all deposits, both here and elsewhere in the world. For another, monetary policy has avoided the mistakes of that ugly time. When financial markets froze in the early 1930s, the Federal Reserve of the day tightened its policy, starving banks for liquidity, exacerbating already severe financial pressures, and contributing to a general price deflation that prolonged the economy's adjustment period for years. In contrast, the federal authorities today have battled the situation by adding needed liquidity to financial institutions. The effort failed to reverse the strain immediately, but such actions, plus, of course, the existence of deposit insurance, argue forcefully against a repeat of the financial collapse that created the great depression and other horribly severe contractions of the past.

In such circumstances, stocks are likely to rise, and could rise robustly into 2009. Such a comparatively bullish outlook hinges not at all in economic optimism. The economy, though not in a depression, will likely remain as sluggish in coming months, as it has during the past 12 months or so. But stocks can still respond positively, just from a lifting of the worst fears of depression or something like it. Similarly, this comparative bullishness relies not at all on a complete return of financial markets to full working order, just on the removal of today's intense fear that they may never again function effectively. The rally likely will remain muted, since it will arise less out of optimism than out of relief from intense pessimism, but the direction seems to point upward, and the market's response could be surprisingly strong.

But while the prospects look reasonably good, investors must also consider the risks. Chief among these is a persistence of today's panic. Despite the fact that markets are already out of touch with the underlying economic and financial fundamentals, they have shown themselves capable in the past of moving contrary to fundamentals for extended times. Though not especially likely, such persistence is dangerous because financial problems, if too severe for too long, can change these fundamentals by feeding back to the real economy and actually create the feared economic hell, however improbable it was at first. Such self-fulfilling prophecies have played a role in past periods of economic hardship and could again this time. There already is evidence of the beginnings of such ill effects.

But though such an extreme event remains a risk, it is not a probability. Markets more likely will return to economic and financial realities, because of the efforts of policy makers both here and abroad and because markets, for all their volatility, tend ultimately to reflect the fundamentals. It is, therefore, more likely that the economy and corporate earnings, if not especially robust, will avoid the severe expectations currently common among investors. The pace of growth may slide into negative territory or it may avoid such an outcome, but it certainly will prove better than the intractable decline commonly anticipated by investors today. Corporate earnings, even if they shrink a little, will likely remain better than the fearful expectations now commonly bandied about under the influence of today's immediate concerns. Freed from such stark fears, stocks should rise.

[1]The Dow Jones Industrial Average is an unmanaged index of common stocks comprised of major industrial companies and assumes the reinvestment of dividends and capital gains.
[2]The S&P 500® Index is widely regarded as the standard for measuring large cap U.S. stock market performance and includes a representative sample of leading companies in leading industries.

Milton Ezrati, Partner and Senior Economic and Market Strategist, has been widely published in a wide variety of magazines, scholarly journals, and newspapers, including *The New York Times, Financial Times, The Wall Street Journal, The Christian Science Monitor,* and *Foreign Affairs*, on a broad spectrum of investment management topics. Prior to joining Lord Abbett, Mr. Ezrati was Senior Vice President and head of investing in the Americas for Nomura Asset Management, where he helped direct investment strategies for both equity and fixed-income investment management.

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