

Waiting for a recovery



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In recent weeks, I have been in the grips of an extraordinarily miserable cold. Growing up in Ireland, I had colds all the time – but they were all very common colds, lasting only a few days. This blighted bug has been with me for three weeks now, morphing from sore throat to fever to laryngitis to congestion and now to bouts of coughing.

Matching the intensity of the cold has been the arsenal of remedies employed to combat it. Matzo ball soup and hot whiskey, potions and pharmaceuticals, warm blankets and fresh cold air have all been pressed into battle. To be honest, I'm not sure that any of these cures are particularly effective, and I can't say, with any precision, when I will be cold-free. Despite this, I remain confident that, in time, I'll be restored to good health.

Much the same could be said of the current state of the economy and financial markets. We are in an unusually intense recession and a brutal bear market, triggered by an extraordinary financial crisis. The recession has been changing character over time and is being met by dramatic policy actions by the federal government and the Federal Reserve. Legitimate questions can be asked about the effectiveness of these measures and we cannot say, with assurance, where or when a bottom will be found for either the economy or markets. We *can* be confident that they will both eventually recover. The question is: what to do while we're waiting?

Old ailments on the mend

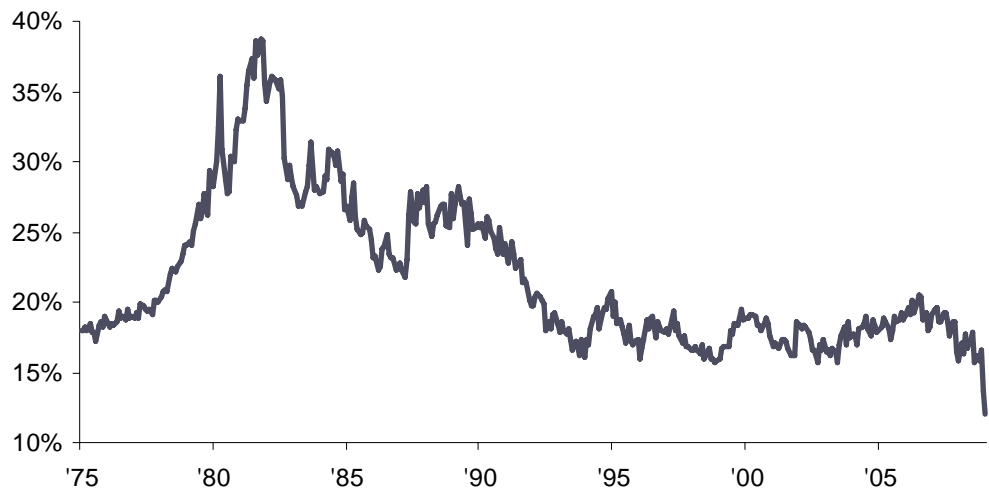
As this is being written, there is no doubt that the economy and financial markets both remain very sick. However, it is worth noting that the problems have changed somewhat over the past year. In 2008, the biggest problems facing the economy were the unwinding of the housing bubble, soaring energy prices and the turmoil in financial markets.

Housing remains deeply depressed. However, if a housing bubble is defined by overpricing and over-building, the housing bubble is gone. In January, average new home prices were down 29% from their peak. This reality, combined with mortgage rates at just over 5%, means that U.S. housing is now at its most affordable, relative to income, since at least the early 1970s.

Inventories of new and existing homes are now at 3.9 million units, down from a peak of 5.1 million units in July 2007. This remains well above the 2.9 million average units on the market between 2003 and 2005, but it still shows some progress. Moreover, given the startlingly low level of home-building, normal demographic growth should be sufficient to soak up remaining excess inventories relatively quickly when sales finally turn the corner. This is not to say, unfortunately, that we have hit bottom in prices. It is to say that prices have probably already fallen too far in most of the country and the remainder of the housing overhang could probably be dealt with in any normal economic recovery.

Housing is more affordable than in any time in recent decades

Mortgage payment on new home, % of average household personal income



Source: Census Bureau, Census Bureau, Federal Reserve Board, BEA, JPMorgan Asset Management. Data are as of 03/06/09.

The energy bubble is also history. Surging oil prices in late 2007 and in the first half of 2008 pushed gasoline prices above \$4 a gallon last summer, acting as a very heavy tax, particularly on low- to middle-income consumers. The collapse in oil prices since then has pushed gasoline back below \$2 a gallon, acting as a tax cut for consumers. To put this in perspective, in 2008, the United States spent roughly \$450 billion on imported oil – this year that number could be as low as \$210 billion. In 2008, rising oil prices acted as a tax on the U.S. economy, worsening the recession. In 2009, lower oil prices should act as a substantial tax cut.

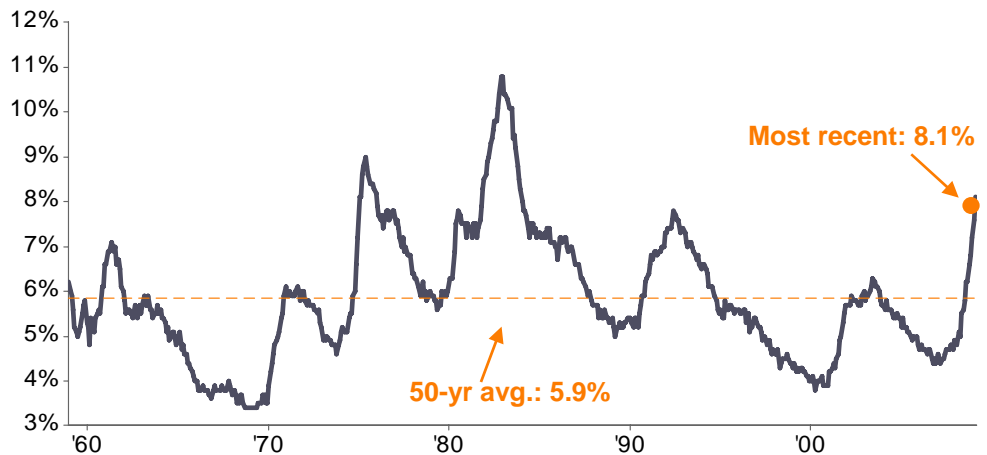
And while the stock market is down very sharply from the start of this year, some of the financial stresses which originally triggered the economic and market slide have abated. Stock market volatility in early 2009, while still double normal levels, is about half as intense as it was in the three months after Lehman went under. Intensive government guarantees have contributed to a narrowing of the spread between Libor rates and Treasury rates, and increased the availability of mortgage credit. And there are signs, again with considerable Federal assistance, of improving conditions in commercial paper and credit markets.

New problems weighing on the market

These are all signs of progress on major issues. But just like my cold, the current symptoms always seem to be the worst, and block out the memory of other discomforts which have since improved.

Among the worst problems the U.S. economy is facing is spiraling unemployment, with a 651,000 job loss in February pushing the unemployment rate to 8.1%. Many have worried that the economy and markets cannot improve until the employment situation turns around. Historically, this is not true; on average, over the past 10 recessions, the stock market has begun to improve before the end of the recession, while the unemployment rate has not peaked until well into the expansion. But there is no denying the negative impact of rising unemployment on business and consumer psychology.

Unemployment jumps to highest level since 1983 Civilian unemployment rate, seasonally adjusted



Source: BLS, JPMorgan Asset Management.

Data reflects most recently available as of 03/06/09.

There is also legitimate concern about the impact of declining wealth on consumer spending and investment decisions. Since their peak in October 2007, the value of U.S. stocks has fallen by an astounding 56%, while home prices are generally down by more than 25% from their peak. This huge drop in wealth, particularly if not reversed quickly, could herald an era of more conservative consumer behavior in general as households scramble to offset the declines in the value of their retirement plans.

And many investors are increasingly concerned about the scale of government intervention. While the Federal Reserve and both the current and previous administrations may argue that they had no choice but dramatic intervention, the scope of Washington intervention in the banking system, the government debt incurred to finance the stimulus plan, and the potential for higher future taxes have all added considerable uncertainty to financial markets.

How will we know it's getting better?

No matter how challenging the current economic environment, it will eventually improve. In the long run, higher productivity and a growing labor force increase the productive capacity of the economy. Moreover, very long experience has shown that all other things being equal, Americans would rather overwork, overspend and try to get ahead. Since 1900, the U.S. economy has been in expansion 76% of the time and in recession just 24% of the time. At some stage, we will return to 5% unemployment and relatively low inflation, and financial markets very likely will have seen a very substantial recovery before that occurs. But, how will we know that the economy is turning?

One *unreliable* indicator is the day-to-day movement in the market itself. Although many financial reporters seem to regard daily stock market movements as a daily verdict on changes in economic direction, the reality is that the market is also very influenced by the simple flow of investor money in and out of equity mutual funds and other broad investment vehicles. If money is trending out of the market, it's very hard for the market to go up, even in the midst of hopeful economic news.

However, there are some signals that we should keep an eye on as potentially early signs of an economic and market turnaround:

Turnaround Indicators

	10-yr avg	Oct	Nov	Dec	Jan	Feb
Housing Starts¹	1,640	767	655	560	466	N/A
Light Vehicle Sales²	16.3	12.5	10.1	10.3	9.5	9.1
Chain Stores³	3.7%	-0.8%	-2.6%	-1.7%	-1.5%	0.2%
Unemployment Claims⁴	358	178	515	491	631	639
Equity Fund Flows⁵	\$8,165	-\$72,510	-\$20,618	-\$20,432	\$9,046	N/A

¹ Source: U.S. Census Bureau. Thousands of units, seasonally adjusted, annual rate.

² Source: Bureau of Economic Analysis. Millions of units, annual rate.

³ Source: Bank of Tokyo-Mitsubishi UFJ, LTD. Same store sales, % change year-over-year.

⁴ Source: U.S. Department of Labor. Weekly initial unemployment claims, thousands.

⁵ Source: Investment Company Institute. Millions of dollars.

Data are as of 03/06/09.

- ✓ The most important signs are probably indicators of the housing market. Falling home sales and housing prices have been undermining the value of mortgage-backed securities throughout this crisis and any improvement in either the pending home sales index or housing starts could be an early sign of stabilization, not just in the economy, but also among financial firms.
- ✓ A second key is vehicle sales, both because of the psychological and financial impacts of continued efforts to sustain U.S. automakers, and because any sign of improvement in this area could significantly help consumer confidence.
- ✓ A third number to look at is chain-store sales, which can turn even before vehicle sales, if consumers have the disposable income to buy basic consumer goods before they have the courage to buy bigger-ticket items.
- ✓ A fourth indicator is weekly unemployment claims. The U.S. unemployment rate is unlikely to hit a peak until new unemployment claims have fallen to about 350,000 per week from their current 600,000+. But a steady reduction in this number to somewhere in the 500,000's or 400,000's could convince many that the pace of job losses is slowing.
- ✓ Finally, it's worth keeping an eye on net flows into equity mutual funds, which were overwhelmingly negative in 2008. While steady inflows are unlikely anytime soon, any slowdown in outflows could be a net positive for financial markets.

These indicators, as shown in the table above, are generally very negative right now. However, they will be worth watching closely in the months ahead.

What to do in the meantime?

Even if the economy will be OK in the long run and we know the numbers to check for signs of a turning point, this still leaves open the question of what to do right now. In this atmosphere of heightened uncertainty, these four principles seem to make sense:

- Make sure you have high-quality bonds or market neutral assets in a portfolio, in case the economy and markets get even worse.
- Be flexible, so you can move into riskier assets, such as high-yield bonds and stocks, if the economy shows signs of turning more positive.
- Make sure you protect yourself against inflation. Price pressures could build if fiscal and monetary stimulus efforts are sustained at too intense a level for too long.
- Think active management. While all active managers are not superior, the huge market disruption of the last year has left many assets underpriced and some assets overpriced. Long-term active managers should be able to take advantage of this.

Most of all, this is a time for logic and rationality. This is undoubtedly the most challenging environment that financial advisors and their clients have faced in recent memory. But the long history of the American economy and American financial markets should give us confidence in the recuperative powers of both. In time, the economy will recover and the markets will reflect that, and clients who have felt the full fury of the downturn ought to make sure that they are positioned to take advantage of the rebound, as well.

Diversification does not guarantee investment returns and does not eliminate the risk of loss. Bonds are subject to interest rate risks. Bond prices generally fall when interest rates rise.

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