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Frequently Asked Questions about the Economy and Stock Market

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In light of the stock market's continuing slide, we wanted to offer our perspective on various questions that clients have been raising about the economy and capital markets generally.

To that end, we've assembled the following frequently-asked-questions about the economy and stock market.

We welcome any feedback you may have. Please direct any questions or other suggestions to our chief investment officer, Jeffrey Ptak, at jeffrey.ptak@morningstar.com.

Why Is the Stock Market Continuing Its Slide?

- Fears over bank nationalization
- Lower earnings expectations given steeper-than-expected economic downturn
- Healthcare sector hit by concerns over Obama administration's budgetary priorities

In our opinion, this most-recent phase of the downturn (stretching from early-January to the present) has been dominated by concerns over nationalization of the banking system. The common-stock prices of many large banks have cratered in recent weeks because investors fear a government takeover would severely dilute their ownership interests. In addition, Wall Street has been trimming its earnings estimates for a wide range of firms to reflect the sharp deterioration in corporate profits and the darkened outlook for the remainder of this year. This is largely a consequence of the economic slowdown, which is taking a toll on financial and commercial enterprises alike. Finally, the healthcare sector has come under siege in recent days amid worries that the Obama administration is likely to take a decidedly less-friendly tack to the pharmaceutical, equipment, and managed-care industries.

When Is the Sell-off Likely to End?

- When the credit markets heal and investors regain confidence in the economy
- Educated guess places onset of economic recovery toward tail-end of 2009/early 2010
- Possible sustained market recovery later this year

Precisely calling a bottom is a notoriously difficult thing to do. That said, we believe that the markets is likely to stabilize as the credit market heals—a process that's gradually unfolding—and investors regain confidence in the economy's prospects. With respect to the economy, we've consistently stated our view that this downturn is likely to be longer and more-painful than the typical recession. If we were to hypothetically assume that this recession will last two years (which is more than twice as long as the median downturn during the post-War period), that would place the onset of an economic recovery in late-2009 or early-2010. Generally speaking, the stock market tends to sniff-out economic recoveries (and downturns) several months in advance. Assuming that held true in this case, one may expect the stock market to stage a more-sustained rally in this year's third or fourth quarter.

How Sharp Is the Rally Likely to Be?

- More likely to be shallow than "L-shaped"
- Stock prices likely to follow earnings, which are tied to economic growth

We have already experienced very sharp, intermittent rallies in the past six months or so. However, all of these advances were overwhelmed by cascading losses, explaining the market's declines. Given our belief that the market is significantly oversold, we would not be surprised to see stocks spurt to a significant gain before long. Ultimately,

though, the pace of real economic growth is likely to dictate the market's trajectory. In view of the significant issues still confronting our economy, including a besieged banking system and a foundering real-estate market, we're not expecting the market to stage a dramatic, "L-shaped" rally. Instead, we believe, it's likely to grind higher as the economy stabilizes and expands anew.

But What's to Prevent the Market from Continuing to Stumble Along the Bottom?

- Earnings unlikely to decline or remain stagnant over an extended period
- Economy's problems are serious, but not intractable
- As credit and housing markets heal, economy is likely to return to the fore
- Lower prices are likely to stimulate demand, spur renewed economic growth, goose corporate profits, propel stocks

To believe that the stock market will remain in a state of gradual decline, or stagnancy, one must subscribe to the view that earnings (adjusted for inflation) will slide or, at best, remain flat. We see no convincing evidence to suggest that our economy's problems, while serious, are so intractable as to preclude growth over the long haul. Though we're under no illusions that the near-term will be a cakewalk, we believe that as the credit markets gradually heal and the housing market shows signs of stabilizing, investors can focus anew on central questions of supply and demand. Generally speaking, recessions are deflationary events--demand for goods and services slackens, pushing prices lower. In simplistic terms, the availability of more-affordable goods and services is what re-ignites demand, as employers add headcount, purchase fixed assets, or pad inventories. That, in turn, spurs economic growth, goosing corporate profits in the process. It appears that the markets remain fixated on the near-term earnings picture, which is very murky given the economy's uncertain state, at the expense of the long-term outlook, which in our view is far more relevant to assessing a stock's intrinsic worth.

Isn't This Just More of the Same?

- No—despite the sell-off, the credit market is *improving*
- Also, not all risky assets have sold-off (healthcare, blue-chip tech, China, Brazil have fared better)

As before, banks are the focal point of the market's recent struggles. However, this sell-off differs from last fall's decline in that it has taken place against the backdrop of a gradually *improving* credit market. Also, whereas investors were punished for holding just about any kind of risky asset (stock, corporate bonds, municipals, etc.) last fall, this pullback has been less monolithic. In fact, Treasury bonds have posted losses year-to-date, while strands of the corporate and municipal bond markets have rallied. In addition, stock market losses have not piled up uniformly. Though the financial sector has gotten crushed, healthcare and blue-chip tech stock have help up better, as have certain key emerging markets like China and Brazil.

Why Does It Matter Whether This Decline Differs from Last Fall's Selloff – A Decline's a Decline, Right?

- Economy is likely to grow only when credit, housing markets stabilize
- Recent conditions encouraging insofar that the credit market has shown signs of thawing

While that's true, the economy is likely to grow only when the credit and housing markets show signs of stabilizing. Although we've seen scant signs that the housing market has bottomed, the credit markets have unquestionably loosened-up. That's encouraging insofar as it signals the market's gathering confidence in the overall stability of the financial system, thereby allowing investors to turn their attention to the economy. (The fact that risky assets haven't sold-off en masse also implies that the most-recent phase of the downturn is not a function of trust evaporating writ large from the markets.)

What Does the Economy Have to Do With This?

- Stock prices generally follow earnings
- Economy drives growth, profitability
- Thus, economy strongly influences stock prices

A stock represents an ownership interest in a business. The value of that ownership interest is, all things being equal, a function of how much cash flow the business churns out over time. That, in turn, depends on the firm's profitability and growth. Stated differently, as go earnings, so go the fortunes of most businesses and their owners. In that sense, the stock market's reaction to the economic downturn is understandable—a recession signifies a contracting economy, which translates to slowing earnings growth, crimped profits, and lower stock prices.

What Has Put the Economy into Such a Deep Rut?

- Economy was already contracting heading into late-2007
- Credit crisis was catalyst behind dramatic fall-off in commercial, consumer spending
- Made more severe by slackening foreign demand, as overseas economies are also suffering

Available data suggests the economy began contracting in late-2007. However, the pace accelerated dramatically in last year's fourth-quarter, a direct consequence of the credit-market's paralysis. In a nutshell, firms became so uncertain about their future prospects that they sharply curtailed new spending and, in many cases, made deep cuts to payroll and other discretionary expenses. Consumers also retrenched in dramatic fashion, as mounting unemployment and an extremely tight credit market chilled discretionary spending. Since virtually every other major overseas economy experienced similar woes, foreign demand has provided little cushion, amplifying the severity of the U.S. downturn.

With No End to the Recession in Sight, Is It Still Worth Investing in the Stock Market?

- With a suitable time horizon, yes
- Economic downturns normal part of market cycle
- Economic growth is likely to eventually revert to the mean, lifting stock prices

Provided one has a suitably long time horizon, yes. Though this recession has already lasted longer, and is likely to cut deeper, than most others, economic downturns are a normal part of a market cycle, the typical one lasting about 11 months. Assuming that economic growth eventually reverts to the norm (roughly 3.3% per annum from 1929 – 2008), we expect stocks to deliver returns that are more-commensurate with the risk they court. (The fact that the U.S. stock market was recently yielding well over 3%, and that price multiples are far from nosebleed levels reinforces our conviction that stock returns, while paltry in the past decade, are likely to improve in the years ahead.)

A Decade Seems Like a "Suitably Long Time Horizon", Yet Stocks Have Declined—What Gives?

- Not all stocks have declined (i.e., emerging markets, small- and mid-caps, etc.)
- Market's round-trip-to-nowhere is hardly without precedent (1930s, 1970s)
- Prolonged periods of nominal stock market returns have historically presaged periods of strong returns

It's true that the U.S. and developed foreign stock markets have declined over the trailing decade ended January 2009. However, it's worth noting that the same has not been true of emerging markets stocks, which have notched respectable absolute returns over the last ten years. In addition, the returns of small- and mid-cap stocks, while hardly sterling on an absolute basis, managed to outpace inflation over that span. Consider also that the stock market has experienced prolonged fallow stretches in the past. For instance, the S&P 500 Index suffered losses in the rolling 10-year periods ended 1938 and 1939 and notched negative real returns for much of the 1970s. Generally speaking, these periods were followed by robust gains in subsequent rolling 10-year periods. This is likely cold comfort to investors who have been depending on stocks to compound capital. But losing faith in stocks in light of the past decade is the wrong lesson to draw, in our opinion, as it obscures the varied nature of returns as well as the inherent cyclicity of the stock market.

What Is Likely to Pull the Economy Out of Its Current Funk?

- Credit market must continue to heal
- Housing market must show signs of stabilizing

It's important that the credit market continue the gradual healing process upon which it appears to have embarked. A less-than-fully functioning credit market deprives enterprises of the capital that they need to make meaningful investments in labor and fixed assets, cutting into economic expansion in the process. In addition, we believe, the housing market must show signs of stabilizing. A reeling housing market is likely to continue taking a toll on consumers, who might retrench by curbing their discretionary spending in order to pay down debt or otherwise mend their ailing finances.

What Has Caused the Problems in the Credit and Housing Markets?

- Consumers, institutions overextended
- Housing market corrected, created huge "collateral call" on assets pledged against borrowings
- Investors rushed to sell assets, deflating values
- Institutions hoarded capital

Consumers and institutions overextended themselves. They spent too lavishly, lent too loosely, or borrowed too heavily. Much of this activity was predicated on the real-estate boom and low interest rates. Seeing their property sharply increase in value, many consumers spent beyond their means, thinking that their increased net worth justified such largesse. Others cashed-out of their mortgages on the belief that their lower-equity/increased debt-load was a non-issue in a climate marked by rising real-estate prices. This activity was aided and abetted by lax lending standards, which made it all too easy for consumers to buy too much house or draw down too much credit. These practices exposed institutions, including banks and mortgage lenders, to an avalanche of potentially troubled loans. When the housing market began to correct, consumers and institutions that had spent, borrowed, or lent against inflated real-estate values came under enormous pressure to hoard capital and pay down the debt they'd amassed. This "de-leveraging" process has unfolded on a massive and financially devastating scale. As investors rushed to sell assets (sometimes indiscriminately) in order to meet collateral calls, they've sharply deflated asset prices, pushing the stock and bond markets down in the process. In the meantime, lenders of capital have sharply curtailed their lending, making it very difficult for troubled borrowers to refinance or restructure their debt obligations and, thus, accentuating the pain.

But Why Does the Financial Irresponsibility of *Some* Afflict the *Whole* Economy?

- The housing bubble was not confined solely to "sub-prime" market
- Broader economy benefited from these excesses, directly or indirectly, before the bubble popped
- Now, the broader economy must deal with the fallout

Though some have pinned the blame for the credit crisis on so-called "sub-prime" borrowers, the housing bubble and related excesses (i.e., excessive borrowing, lax lending) were hardly confined to at-risk homeowners alone. In fact, many "prime" borrowers levered-up to an unhealthy extent or engaged in speculation. In addition, the leverage glut was not unique to the housing market—countless companies levered their balance sheets to an irresponsible degree. While these actions seem regrettable with the benefit of hindsight, it's worth noting that the broader economy—which spans consumers across all credit-quality strata—benefited from these activities. For instance, retailers and restaurants would not have racked-up impressive gains in same-store sales from 2003-2007 absent consumers' willingness to indulge—something made possible, in part, by the housing bubble and all-too-freely available credit. Similarly, many employers would not have hired absent the availability of cheap sources of debt financing. These activities spurred economic growth and that growth conferred benefits on a wide expanse of consumers and commercial enterprises.

What Is Likely to Induce Needed Improvements in the Credit and Housing Markets?

- Renewed confidence
- As confidence re-emerges, capital becomes more readily available, spurring growth

Renewed confidence. The federal government and monetary authorities are pouring stimulus of various kinds on the financial system and housing markets and have introduced various other measures to undergird the stability of the credit markets. These facilities have taken a variety of forms, from capital infusions into banking institutions, to backstops of money-market funds and securitization markets, to proposed plans to modify troubled home loans. These efforts have but one purpose—to re-instill confidence in these markets, thereby attracting fuller participation by investors (i.e., lenders of capital, purchasers of home loans, buyers of residential property, etc.). As this unfolds, capital is likely to become more readily available, providing a needed jolt to the economy.

S&P 500 Index - An index of 500 stocks chosen for market size, liquidity and industry grouping, among other factors. The S&P 500 is designed to be a leading indicator of U.S. equities and is meant to reflect the risk/return characteristics of the large cap universe. Companies included in the index are selected by the S&P Index Committee, a team of analysts and economists at Standard & Poor's. The S&P 500 is a market value weighted index.

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