by James Swanson, CFA

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Shock absorbers appear to be in place to blunt downturn

Admittedly the mood is gloomy out there. We should, however, find solace in knowing that there are quite a few shock absorbers that could soften what might otherwise be a hard landing. I believe the return to stability should thus be easier and come earlier.

While opinion is somewhat mixed on the makeup of the stimulus and bailout packages, it is hardly mixed about the need for such a package. As Barack Obama said, failure to act could turn a crisis into a catastrophe. Strong action is needed to fix not just our own economy but to get the gears of the global economy turning.

In my view, the efforts of the U.S. Federal Reserve Board and the U.S. government have blunted the blows the economy has taken and have created the necessary shock absorbers to prevent this recession from becoming a depression.

Shock absorbers may help avert depression scenario

- **Better monetary policy:** The Fed has learned from past mistakes and in this crisis has gotten in front of the curve by aggressively lowering interest rates. In addition to cutting its key policy target to zero, the Fed has expanded its arsenal of monetary policy tools to include offers of aid to banks and other firms and the commencement of quantitative easing. That strategy includes the purchase of mortgage-backed bonds and commercial paper to help unfreeze the credit in those areas.
- **Lower mortgage rates:** The central bank is making a concerted effort to lower mortgage rates for new home buyers and to further the downward move in rates for refinancers. This should free up consumer spending as well.
- **Government stimulus:** A good part of this money will have an effect on the economy and help slow the downward spiral that we have been witnessing during the past few months. I expect it will add about one to one-and-a-half percentage points to U.S. gross national product.

In addition to government and Fed-led initiatives, falling energy and food costs have helped to free up money that consumers can spend elsewhere. These lower prices should add an additional percentage point to GDP.

So what is the takeaway? While we are in a recession, this is not a repeat of the 1929 to 1938 period. Today's events do not parallel those that transpired during that depression.

We are facing what should prove to be a difficult three to six months for the economy. We can expect more bad news: softening labor markets, weak car sales, a rise in corporate defaults, and a decline in consumer spending.

Given the broader scenario, what can we anticipate from the markets? And what have they priced in?

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Fixed-income markets

Credit markets will lead the market recovery. Already we are witnessing a slow thawing, which means spreads are narrowing. We have seen improvements in all areas of the markets — high-grade bonds, high-yield bonds, municipal tax-free bonds, and convertibles. Spreads in all of these areas are narrowing, but prices still remain near historic levels of cheapness. When looking to allocate new money, investors might consider a package of high-grade bonds, which could provide income with less risk in this dark and uncertain period. Cash yields should continue to hover near zero, as they are governed primarily by the target that the Fed sets. The yield on the longer-term Treasuries will likely remain range bound as the government tries to bring mortgage rates down.

Equity markets

The Standard & Poor's 500 Stock Index has declined about 40% from its peak. The question for investors is whether stocks have priced in all future events. In my view, stocks have not fallen so far because they were overvalued. Rather, I believe that the extreme decline in equity markets is part of the collateral damage particular to this economic decline. At this time we have seen fourth-quarter earnings reports from 30% of the companies in the S&P 500, and it looks like the run rate is 25% below peak earnings. We expect this trend to continue in the first quarter of the year. The declines will be comparable to losses in the worst two recessions since World War II — those of the seventies and eighties. But the declines are nothing like those faced during the Great Depression or after the collapse of the real estate market that plunged Japan into recession in the 1990s.

Bright spots on the landscape are companies in the health care and industrial sectors and those involved in infrastructure projects. Companies in these areas have reported relatively good results in a bad environment. All in all, stocks have priced in a lot of pain, but in reality no one can call a bottom. My best guess is that with all the liquidity on the sidelines, investors will eventually begin to take a close look at large, stable, underleveraged companies that pay dividends.

Source: MFS research

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