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The debunking of fear signals further stock market rallies

By Jim Paulsen
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Fear has played a dominant role in the current crisis. The economic freefall that characterised the recent recession at least partially resulted from paralysing fears of economic Armageddon among policy officials, businesses, consumers and investors. However, could the severity of these past fears now be helping to revive the economy and could they constitute a force for future growth?

The unprecedented number, variety and magnitude of economic policies employed in this crisis reflect an atypical level of panic among policy leaders during the heat of the crisis. Not only were many financial risks uncommonly backstopped (eg: money market fund guarantees, Federal Reserve buying of mortgage securities and massive bank capital injections) but the size of traditional economic policies was unparalleled. The great Fed balance sheet expansion has left more than $1,000bn in excess reserves in the banking system, annual federal deficit spending has soared to a postwar record of 10 per cent of nominal gross domestic product, long-term Treasury yields have declined and remain near postwar lows and short-term interest rates are zero. Moreover, subsidies have been gifted to homebuyers, moratoriums have been placed on foreclosures, unemployment benefits have twice been extended and an extraordinary multi-faceted $787bn government spending package was passed in early 2009. Finally, despite three consecutive quarters of healthy real GDP growth, the Fed still considers the recovery fragile and refuses to lift the federal funds rate from zero. How do you orchestrate the most accommodative postwar economic policy programme? Panic policy officials!

The responses of businesses to this crisis should also boost economic growth. First, in preparing for depression, most companies significantly downsized operations by purging payrolls, inventories and capital spending programmes. However, US business reacted to a classic "bait and switch" - told to prepare for depression, but instead face a recovery. The fear-induced business purge will therefore need to be reversed, adding to this recovery's rate of growth. Second, the cancellation of capital spending programmes and the hoarding of liquidity in recent years has left US corporations with a cashflow to capital spending ratio near a 50-year high. Finally, the crisis-induced business purge has produced the greatest operating profit leverage in decades. The profit recovery cycle should continue to impress as this new-found operating leverage is just now being taken out for a sales drive.

In early 2009, the Conference Board's consumer confidence index was 70 per cent below its previous low of December 1974. Household confidence was obliterated. Many healthy households (those that had a job, an income and manageable debt burdens), paralysed by fear, stopped spending. Job losses were a real problem in the recession, but so was the fear-based freeze of 90 per cent of households that never lost their job. These now find themselves with excess savings (for a depression that wasn't) and postponed purchases. Household cash has risen to almost $7,500bn and is near a 20-year high in relation to disposable income. Armed with panic-induced savings, pent-up demands and cash hidden in their mattresses, as confidence slowly improves households may prove a surprising force for future growth.

Finally, the "debunking of crisis fears" also seems to be driving the stock market. It was driven from its recession low in March 2009 because fears of a second depression were discredited. Similarly, since late last year, the stock market has struggled with another crisis fear - vulnerability to a double-dip recession. However, is the current push in the S&P 500 towards 1,200 the start of another rally driven by the debunking of double-dip fears? Even if double-dip concerns fade, they will likely be replaced by the ultimate investment fear created by the 2008 crisis - "a new-normal (and perpetually sub-par) economic recovery". Discrediting this last fear may be some time off, but it represents further upside potential for stock investors.

While excessive fear made the recession much worse, it also may help produce a much better than anticipated recovery. The panicky posturing of our leadership scared many into economic paralysis, but the massive economic stimulus may also produce a strong recovery. Businesses preparing for a depression surely made the recession worse, but a reversal of this corporate purge should boost recovery growth and elevated profit leverage could keep surprising most earnings forecasters. The legacy of excessive household fear is improved savings, stronger pent-up demands and a mountain of cash.

Finally, the financial market panic leaves investors woefully under-exposed to stocks, with easy-to-beat expectations, a large pool of liquid-asset buying power and a stellar outlook for profits.

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