THE VALUE LINE FAMILY OF NO-LOAD MUTUAL FUNDS

No-Load Mutual Funds

NewsAlert

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An Economic Perspective

The recession shows signs of being over, after having contributed to the worst stock market debacle in decades, wreaked untold havoc on millions of retirement accounts, produced massive losses in wealth among tens of millions of homeowners, cost millions of jobs in scores of industries, and brought several sectors—notably automotive and financial services—to their knees. Indeed, the 2007-2009 recession was, by most accounts, the worst since the 1930s. Our cautious optimism on the U.S. business outlook now, in large part, reflects the release of data showing that the nation's gross domestic product—a broad measure of the value of all the goods and services produced—which had fallen by 5.4% in last year's fourth quarter and by an even more unsettling 6.4% in this year's initial period, came out of its tailspin in the second quarter, fell by a more moderate 1.0%. That was a better showing than had been expected. In fact, one of the reasons the economy contracted at all during the quarter was that business inventories declined, as already stored goods and services were consumed rather than new items produced. (Production, not consumption, adds to GDP.) Now, with their shelves bare or approaching that status, businesses are in a position to ramp up production in order to restock those shelves. That restocking process should now add to GDP, producing what we believe will be modest growth in the neighborhood of 2% in the second half of this year—thereby officially ending the long and painful recession.

There is more to the brightening picture than a moderating GDP decline. We also have continued to see lesser setbacks in both manufacturing and nonmanufacturing, witnessed emerging stabilization in homebuilding and home sales, and enjoyed modest, albeit irregular, gains in consumer spending. True, things are hardly booming, as the selective improvements cited here are off of historically low levels. However, the recovery now seemingly under way should be sufficient to push GDP comfortably into the plus column in the second half of this year, with likely average gains in the neighborhood of 2%. That would hardly qualify as an eyecatching performance, but it would be better than we thought possible a few months ago—when the economy was contracting sharply and a business recovery appeared to be nowhere in sight.

The evolving economic recovery is likely to be selective in its formative stages. Following the 2%, or so, gain in GDP in the third quarter, the economy—on the strength of further irregular improvements in industrial and consumer activity and possible added inventory building—may press forward by a bit more than 2% in the fourth quarter. Such a showing would still trail the pace of some prior business recoveries, which had started with more of a flourish. This time, though, home prices continue to decline in certain locales; payrolls are still falling; unemployment is stubbornly high; and millions of retirement accounts are worth much less than they were two years ago, even after the stock market's sizable recovery since March. Such an undistinguished setting is unlikely to yield the vigorous consumer spending needed to set into motion a "normalized" economic expansion right away. Time and additional base building will be needed before that happens, in our opinion.

Even next year's economic performance is unlikely to be memorable. Our sense is that the economy will show further moderate strength in 2010, with GDP growth holding in a range of 2%-3%, for the most part. Such improvement may not be uniform, however, as the recoveries we expect to evolve across a broad range of industries may be uneven. Meanwhile, two key ingredients needed for even this moderate recovery to unfold will be stabilizing home prices and rising employment—both of which we now expect sometime during the second or the third quarter of 2010. In fact, by late next year, home prices could even be edging selectively higher, payrolls should be increasing, and unemployment might be retreating. We caution, though, that the damage inflicted on the economy over the past two years has been severe. So materially stronger levels of housing and employment may not take hold until 2011. By then, we expect aggregate economic growth to push up into the more "normalized" 3%-plus range. We expect that healthier level of growth to continue through mid-decade. We note that such a benign view excludes possible exogenous shocks to the system, including an extended war, a terrorist attack, a global drought, or a pandemic—none of which can be predicted with any degree of accuracy. Our forecast also fails to take into account a serious misstep by the Federal Reserve Board on the monetary front or by Washington on the fiscal side.

Meanwhile, there continues to be progress on the earnings front, as most companies reporting for the second quarter and the weeks subsequent to that period generally met or exceeded expectations. To this point, much of the improvement has been from cost cutting. We think that will be the case throughout the second half of this year. The revenue gains needed to push earnings up strongly may not arrive en masse until mid-to-late 2010, when stronger business activity and recovering consumer demand should allow increases in volume. Here, as well, the recent performances have been better than we thought likely in the spring, when doom and gloom was the rage on both Wall Street and Main Street.

The bulls continue to retain the upper hand—for the most part, as stocks have managed to forge through one barrier after another. Of course, as with the economy itself, the numbers must be kept in perspective. The surge by the Dow Jones Industrial Average past the 9,000 level over the summer was quite impressive, as that venerable 30-stock index had come back from the 6,500 area in early March of this year. However, that lower level came after a horrific decline during the preceding 16 months, which had seen the Dow plunge from more than 14,000 in October of 2007. It should be noted that this comeback could prove to be the initial phase of a new bull market; conversely, it may turn out to be little more than a sharp rally in a bear market, which, at times over the years, has retraced a third, or more, of a decline. Time will tell what we have on our hands now.

We are cautious about prospects for the stock market going forward, in part because we have come a long way in a short period of time, with just scattered profit taking along the way. The stock market's rebound from earlier downward excesses has been predicated on the expectation that recent monetary and fiscal initiatives would lead to a sustainable recovery in the economy and corporate earnings. We may now be in the nascent stages of just such a comeback. However, the recent level of the market would seem to price in a lot going right. We think that a solid economic and corporate earnings comeback is, indeed, in the cards for the next year or two. We note, though, that should there be delays or even a succession of disappointments along the way—which is normal during a transformation from recession to recovery—the market's reaction could be swift and decisive. Thus, while we are not precluding further advances in the equity market in the next six months or so, there could well be some turbulence along the way. So caution appears warranted.

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