October, 2009

By William C. Jerome, CFP

Since my last letter in July the markets have rallied. We still haven't seen the pullback everyone is expecting, but that doesn't mean it won't happen. However short term fluctuations are not important if your time horizon is in years, as it should be. In the long run the stock market follows the economy.

The economy is turning around. Most economists are looking for GDP to turn positive in the 3rd quarter ending September 30. The index of leading economic indicators, chosen for their ability to predict the future direction of the economy, has been up for the last five months in a row. Historically, "the most important determinant of the strength of an economic recovery is the depth of the downturn that preceded it. There are no exceptions to this rule, including the 1929-1939 period." I'm quoting Michael T. Darda, an economist, quoted in the *Wall Street Journal*, 9/19/09.

Another reason for optimism, cited by James Grant in the same article, is this: Since World War II the government's average response to a recession has been 2.6% of GDP as fiscal stimulus (increased federal budget deficit) and 0.3% of GDP as monetary stimulus (increase in Federal Reserve balance sheet) totalling 2.9% of GDP. In the current case, those numbers are going to come to 10% and 9.5%, totalling 19.5% of GDP.

In the short run, the market is chaotic and unpredictable. But in the long run, the economy will recover strongly and the markets will lead and predict that recovery. They are doing it now.

I've spoken to a number of people who are worried that another downturn like the last one would ruin them financially. But at this point the bubbles have burst and the economic recovery shows every sign of being real. Bad years in the stock market tend to be followed by good years, which is why the volatility drops and the certainty of good returns increases as you look at longer time periods.