

This briefing is longer than usual—if you can't face reading it all, please note the following areas that we will cover so that you can skip to the relevant section -

- Background: While the Economy Goes Backwards, the Markets Race Ahead
- Comparison to Other Recessions
- What Do Past Recoveries Look Like?
  - ◊ Black Monday
  - ◊ The Tech Crash, 9/11, Accounting Scandals and Wars
- What Will This Recovery Look Like?

## WHILE THE ECONOMY GOES BACKWARDS, THE MARKETS RACE AHEAD

That statement doesn't seem to make sense. Recessions are periods when profits fall, people are made redundant, and money is generally tight. Surely this is the best time to **SELL** equities?

Nevertheless, in the often contrarian world of investing, it seems recessions have historically been a time to buy.

Economic cycles can be broken down into four main phases - recovery, expansion, slowdown and recession.

Since 1950 there have been nine recession phases in the US, and they have just entered another one. Research shows that in the US, equity returns have historically averaged nearly **15% ahead of cash** during a recession and investors buying into the market at the beginning of the phase would have made positive returns above cash **88%** of the time. See the table below:



	Recovery	Expansion	Slowdown	Recession
% Return Above Cash	8.6	8.8	-8.1	14.6
% Of The Time Returns Beat Cash	100	83	22	88

\* Excess return is annualised on S&P500 over cash. Source: Schroders

These are US figures, but the story in the UK is similar.

Currently, we are in slowdown although it is accepted we are actually in an early stage recession.

Officially, a recession is two or more successive quarters of negative GDP growth, and to date we have only seen one flat quarter, and one negative quarter.

The recession will become official when the next figures are published at the end of December.

As usual past returns are no guide whatsoever to future returns. However, this past behaviour provides a real insight into the typical behaviour of markets.

So why would the worst performing periods for stockmarkets be in the slowdown (the phase before a recession) and the best performing period be the recession itself?

As we have said many times, stockmarkets are forward looking. Traders try to anticipate future events and this is factored into prices today. Markets are usually looking 6 to 12 months ahead.

## Uncertainty

One thing that markets hate is uncertainty. There is an old stockmarket expression "buy on the sound of gunfire" (Baron De Rothschild). Markets perform awfully when they think there might be a war. However, as soon as the first shots are fired, investors have certainty and can therefore make rational decisions.

Markets tend to shoot upwards once a war has started. The invasion of Iraq in March 2003 is a great example, as it almost precisely co-incided with the end of three years of market falls, and the beginning of four years of gains. The FTSE Allshare rose over 122% from that point until July 07.



A similar story appears to apply to recessions. If investors think there might be a recession, markets are nervous. They don't know what is going to happen, or how bad it may be.

As soon as it becomes clear there will be a recession, markets can see the light at the other side of the tunnel, make genuine estimates about companies that will and won't be affected, and make rational decisions.

Markets also tend to over shoot what is fair value, both when they rise and when they fall. Momentum gathers and once stocks start to fall (or rise), investors jump on the band wagon and sell (or buy) not because of some in depth analysis, but because everyone else is.

## Compared To Other Recessions

The most recent figures from the International Monetary Fund and the Bank of England, forecast 1.3% of "negative growth" (economic speak for "falls") in UK economic output during 2009. If this is right this is a "peak to trough" movement of 2% (from plus 0.7% to minus 1.3%).

The IMF is then predicting a significant bounce in the second half of next year and continuing strongly thereafter, but more of that later.

Compare this forecast to the 2.5% shrinkage in our economy in the early 1990s. The FTSE Allshare fell around 18%, peak to trough. It then grew around 125% over the next five years.

The early 80s slide in the economy was 6.1% and markets barely even flinched, continuing to grow pretty much unchecked for the majority of the decade (excepting Black Monday, more in a moment).

The 1970s saw similar shrinkages in the economy. However, a number of other factors meant that stockmarkets fell 33% in 1973 and 51% in 1974. This was followed by a recovery of over **145%** in the next year.

The current shrinkage is forecast not to be as bad as the early 90s. However, at its worst point in late October this year, the Allshare was down over 40% from its peak in July 2007.

Whilst we are not able to say with certainty that we have passed the bottom of the market, we do believe that any further losses will be recovered quickly when markets rebound.

### We can make a number of observations

- The current recession is forecast to be less steep than the 1990s.
- Markets have already fallen twice as far as they fell in the early 1990s.
- Markets have tended to do well in recessionary periods and the periods immediately following.

## WHAT DO PAST RECOVERIES LOOK LIKE?

We have already seen the big recoveries following recessions in the 1970s and 1990s. The next pages gives some other examples of five year returns over various periods, including major stockmarket downturns and their recoveries afterwards.

### Black Monday



A client who invested 6 months prior to Black Monday would have been extremely concerned to see their investment fall over 25% in a day. However, five years later their investment would be up 58%.

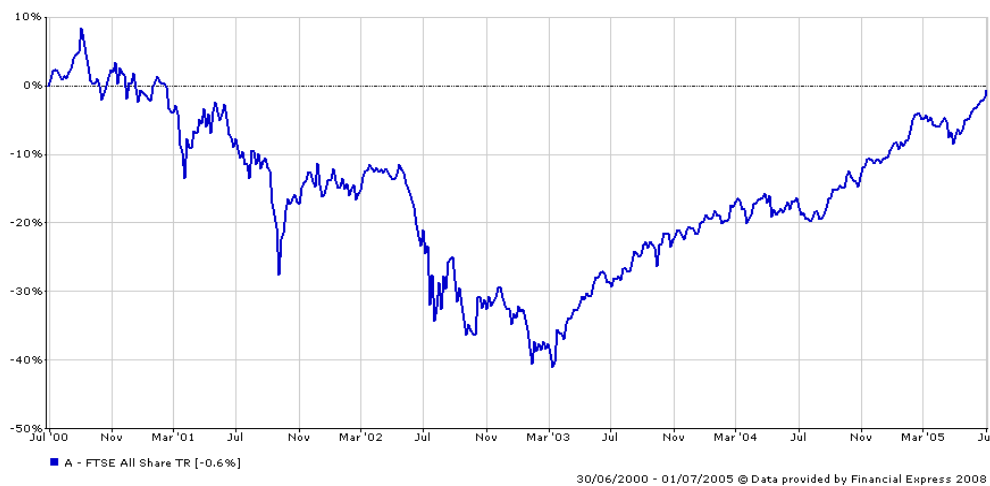
Those brave few that invested in the months after Black Monday (or topped up their holdings back to previous levels) would have done very well indeed.

### The Tech Crash, 9/11, Accounting Scandals and Wars

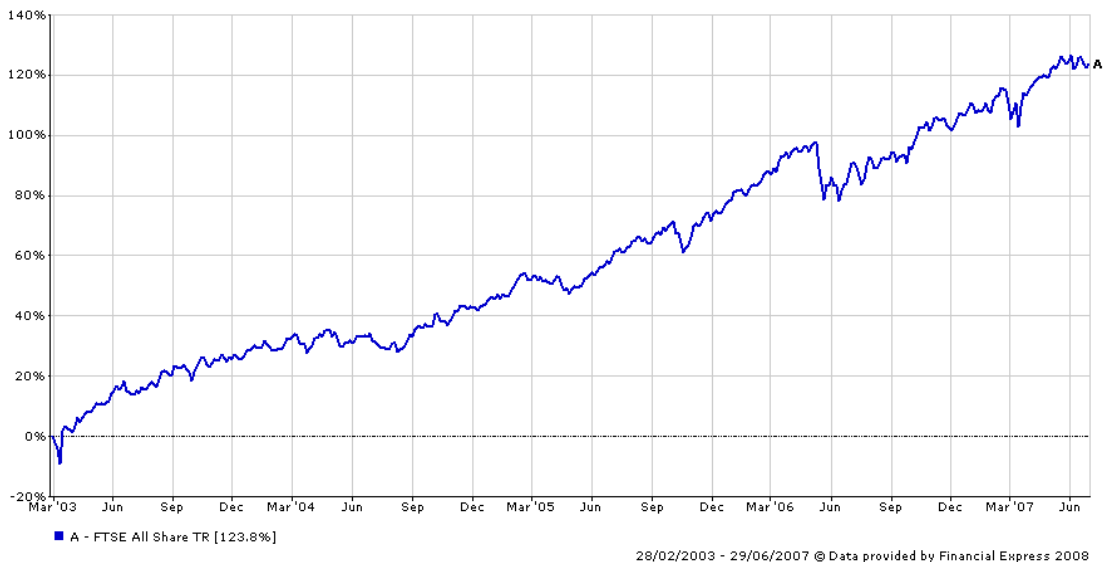
The market downturn in the early part of this century was notable for the length of time it continued. First the technology bubble burst, followed closely by 9/11, the accounting scandals of Enron and Worldcom, and wars in Afghanistan and Iraq.

These combined factors led to a sustained negative period lasting the best part of three years.

Significantly though, despite those three years of losses the market regained most of its ground over the next two years:



If we look at the same event but beginning at the bottom and ending in July last year, we see the scale of the recovery (123% gain):



## WHAT WILL THIS RECOVERY LOOK LIKE?

There are certain key drivers which we would expect to lead to a market recovery:

- **Low interest rates.** Rates have been cut sharply and we expect further cuts to come.
- **Stability in the banking sector.** This is just beginning to happen but will strengthen once some of the agreed actions are completed.
- **Inflation to come down and stabilise.** The first part is beginning to happen and the Bank of England are now more concerned about being below their target than above it.
- **A return to fundamental analysis of which companies will do well and which will do poorly, rather than blind panic!**

Based on previous recoveries, it does not seem unrealistic that we could be back to where we were 18 months ago within a relatively short period of time.

We are not making any predictions, but if we did see a return from the current FTSE level of 4,000 to 6,700 as we were last July, this would be a capital return of around 67%.

If this happened over three years and you add the effect of dividends, a return to the levels of 18 months ago could result in around 25% a year growth (non-compound).





*We hope you found this briefing informative. If you have any queries, please contact your usual adviser.*

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
### General Economic Overview

It is now generally accepted (but not yet official) that we are in a recession. Recovery could begin midway through 2009 and continue strongly throughout 2010.

We believe inflation could fall below the Bank of England's *lower* target and further interest rate cuts are very likely.

Asset Class	Applewood View
<p><b>Equity Markets</b></p> <p>Sticking to our theme of fundamentals, markets do look extremely cheap on a number of indicators. The yield on the UK stock market is currently 2.7% higher than the yield on 10 year UK government bonds. This has historically been a strong "buy" signal.</p> <p>Once some certainty returns to markets we believe we could see a strong recovery. However, we still expect some short term volatility.</p>	
<p><b>Fixed Interest</b></p> <p>As detailed last month, we are very positive for long term returns on fixed interest, particularly corporate bonds from strong companies.</p> <p>As with the stockmarket, we are looking to see some measure of certainty before recovery really gets underway. Once this happens, we could easily see double digit annual returns over the next couple of years.</p>	
<p><b>Commercial Property</b></p> <p>Little change from last month where we said we are expecting further falls in direct commercial property of maybe up to 20%. This market may begin to recover towards the end of 2009.</p> <p>We believe property shares are likely to reach a point where they look very undervalued in the near future.</p>	
<p><b>Residential Property</b></p> <p>Again, no change here and we expect further house price falls, possibly up to 30%. The lack of available borrowing for many prospective purchasers will continue to reduce the number of buyers, therefore reducing prices.</p>	

### Key:

Positive Outlook		+1 is slightly positive, +5 is extremely positive
Negative Outlook		-1 is slightly negative, - 5 is extremely negative
Neutral Outlook		Asset class expected to behave normally

These represent Applewood's collective views. There are no guarantees, although we hope to be right more often than wrong. We usually recommend holding at least some funds in all asset classes at all times and adjust weightings to reflect the above views. These are not personal recommendations so please do not take any action without first speaking to your adviser.