FUQUA'S FINANCE EXPERTS PREDICT ECONOMIC RECOVERY

FEATURE BY ASSOCIATE DEAN **JIM GRAY**

Shown at left: Fuqua Professor John R. Graham

What are the secrets of the current recession and stock market in 2002? Is there a way to turn adversity into opportunity?

And what is the role of the *Wall Street Journal* in all of this uncertainty?

As *Exchange* set out in January to interview knowledgeable sources about the economy and get a fix on when this recession will end, it became clear that four of the internationally respected experts are here at The Fuqua School of Business. They are our Dean, Douglas Breeden, and three other top finance professors, Campbell Harvey, John Graham and Robert Whaley.

Though they made it clear an analysis of the recession or creation of an investment strategy should involve much more than a daily financial newspaper, each used the *Wall Street Journal* to make his points.

WHEN DID THE RECESSION REALLY START?

Turn back the clock to a year and a half ago.

On Friday, October 13, 2000, Fuqua's Cam Harvey was on the telephone to the *Wall Street Journal*. He was telling the *Journal's* Stephen Vames about his yield curve indicator. Harvey's research shows that when long-term interest rates fall below short-term interest rates—recession follows. The indicator has been 100 percent accurate over the past 35 years.

"The yield curve indicator was negative again, having inverted in July 2000," Harvey said. "I told Vames that my indicator forecasted a recession beginning in March 2001. He didn't buy it." After many telephone calls and interviews, the *Journal* elected not to run the story.

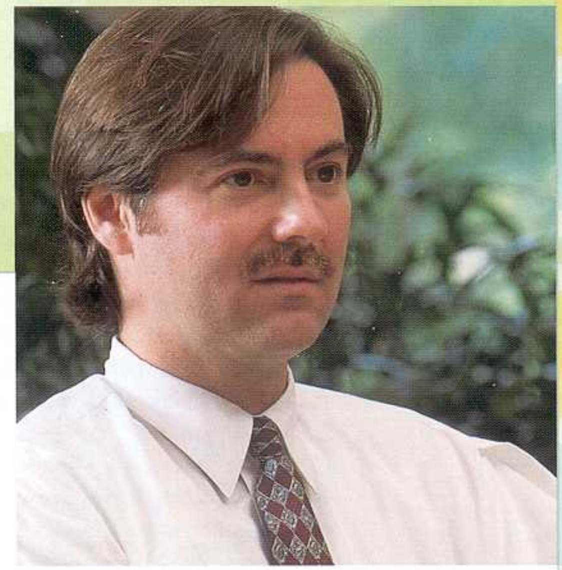
"My forecast was wildly different than consensus. The stock market was riding high. Why listen to the academic viewpoint?" remarked Harvey. "In 1989, only the *New York Times* had the foresight to go with my prediction of a recession beginning in mid-1990." (That recession began in July 1990.)

Fast forward to last fall. The National Bureau of Economic Research (NBER) announced during the second week of November 2001 that the recession began in March 2001. Harvey, again, was right.

"By the second quarter of 2001, the economy had stalled. Real growth was 0.3 percent on an annualized basis. In addition, the market was beginning a sell-off that would strip $4 trillion in value from investors," said Harvey.

The September 11, 2001 crisis was the last straw. "Even before the crisis, the economy was in recession. We already had a string of eight consecutive monthly declines in industrial production. The crisis made the dating of the recession faster and less controversial," he said.

THE LATEST GRAHAM-HARVEY SURVEY, WHICH WAS COVERED PROMINENTLY IN THE DECEMBER 14 *WALL STREET JOURNAL,* SUGGESTS THAT CFOS ARE BEARISH ON THE PROSPECTS FOR THE STOCK MARKET OVER THE NEXT 12 MONTHS — BUT MORE OPTIMISTIC OVER THE LONGER TERM.



Fuqua Finance Professor Campbell R. Harvey, (pictured above) stated "...personal income was not showing a decline. The strength in personal income is a sign that the recession will be shallow."

The NBER committee on the dating of the business cycles considers employment, sales, personal income and industrial production.

Three of the four indicators had clearly peaked. "Only personal income was not showing a decline," remarked Harvey. "The strength in personal income is a sign that the recession will be shallow."

No one fully understands the reasons for the business cycle. The last recession ended in March 1991. The 10-year economic expansion is the longest in the NBER record — which goes back to 1854. Indeed, the expansion was more than double the average length of expansions since 1945.

Harvey, whose recent research examines the factors that contribute to GDP growth in many countries, points out three facts learned from a historical examination of the U.S. business cycle.

"Expansions are longer, recessions are shorter and the volatility is getting smaller." Volatility refers to the depth of the recessions.

The average length of a recession since 1945 is 11 months. Before 1945, the average cycle was 21 months. The last recession lasted only eight months.

WHEN WILL THE RECESSION END? HARVEY AND BREEDEN SAY MARCH 2002.

"If this were an average recession, it would end in February 2002," says Harvey. He is quick to add that there are a number of confounding factors.

"This is wartime recession — and an unusual war. War means extra risk. During the Persian Gulf war, there was a clear target. Success could easily be measured. In the current war on terrorism, success is difficult to measure. The war could take a very long time," he said.

Harvey argues that this introduces additional uncertainty. Indeed, a survey of corporate executives on the outlook for the stock market conducted by Harvey and Fuqua's John Graham provided evidence of increased risk.

Graham said, "One aspect of risk is just how much disagreement there is in the economy. By chance, Cam and I sent a survey out to thousands of CFOs on September 10, 2001. We received responses on the 10th and afterwards. The responses indicated that CFOs view the stock market as being more risky post-September 11."

The latest Graham-Harvey survey, which was covered prominently in the December 14 *Journal,* suggests that CFOs are bearish on the prospects for the stock market over the next 12 months — but more optimistic over the longer-term. They are close to the Harvey-Breeden projection of the recession's anticipated end in March 2002, but hedge those predictions by including the third quarter in their prediction.

"The end of this recession is difficult to forecast because there could be a war-related shock that sets us back. Nevertheless, there was a small positive growth registered in the fourth quarter of 2001," says Harvey. "My yield curve model, before September 11, suggested a relatively short recession, three quarters. Given the added uncertainty regarding the war, my best guess is March 2002 as the official end."

Breeden agrees with Harvey that the recovery is most likely to begin in March.

BREEDEN SAYS SOME INDICATORS ARE ROUTINELY IN THE *JOURNAL*.

Dean Breeden points to the *Wall Street Journal* on his desk for confirmation. Buried deep within the "Money and Investing" section of the newspaper are two clues to predicting the recession's end.

"Look at the LIBOR numbers," Breeden says of the London Interbank Offered Rate (LIBOR) that is found daily on the "Futures Prices" page of Section C. "If you focus on the Eurodollar futures prices (rate=100-price), you will see what interest rates the big banks use to lend money to each other in the transactions of the highest quality, both at present and expected in the future."

Shown at left: Fuqua's Finance Professor and Dean, Douglas T. Breeden

In early January (*Wall Street Journal* January 9, 2002), Eurodollar futures prices gave projected LIBOR of 1.94 percent in March 2002, then 2.34 percent in June, 2.85 percent in September and 3.46 percent in December 2002. "The sharp increase in rates that is projected to start between March and June 2002 indicates that highly informed market participants believe the economy will pick up steam at that time," Breeden says, agreeing with Harvey.

"What that also indicates is that people should not feel like they are leaning over the edge of a crevice and seeing a bottomless pit of a long-lingering recession," Breeden said. "Normalcy is on its way."

AS NORMALCY RETURNS, WHAT SHOULD INVESTORS DO?

Breeden again points to the *Journal*—this time to the Volatility Index (VIX) in the "Ranges For Underlying Indexes" section of the Listed Options Quotation page. He calls it a "barometer of worry."

"When times are calm, the index is low, say in the 20 percent to 25 percent range. It has been much higher than that during this recession—about 26 percent during much of December 2001. So as people see the VIX going down to that normal range, things are getting back to normal," he said.

Fuqua Professor Bob Whaley, who designed and developed the VIX for the Chicago Board Options Exchange in 1993, agrees with Breeden's interpretion. He said, "The VIX is set by investors through the prices they are willing to pay for index options. It expresses their consensus view about expected future stock market volatility. The VIX closed the year 2001 at 22 percent, near its lowest level for the entire year. This comfort level is quite surprising considering VIX was as high as 49 percent in the aftermath of September 11 just three and a half months earlier."

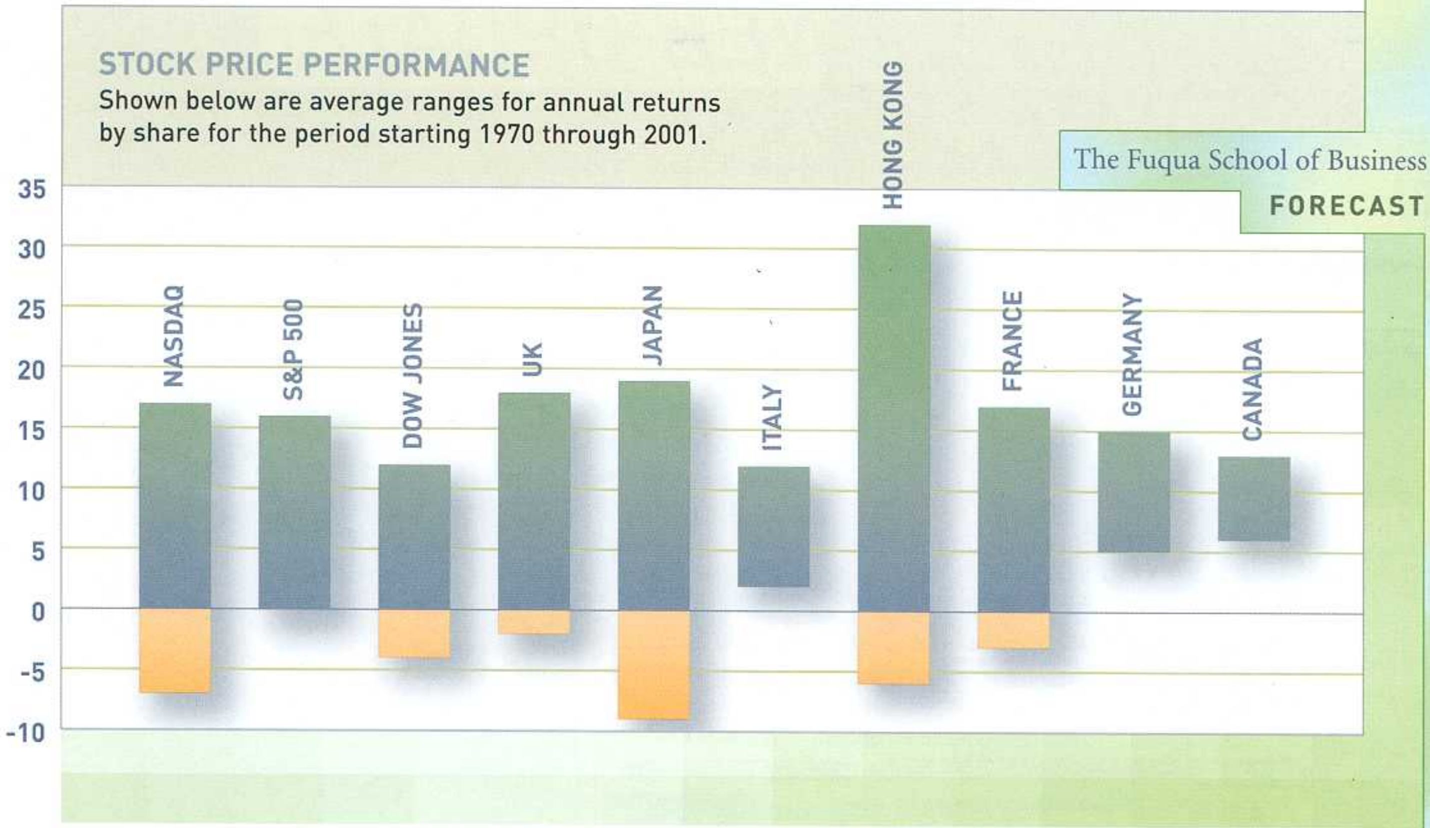
What should we do with our personal borrowing and investments as we come out of the recession in early 2002?

"Go back to behaving normally, being conservative with your debt but getting back to normal levels of buying, holding and selling stocks and bonds," Breeden advises, "but remember that it's a dangerous world out there. These indices and our interpretation of them may be wrong, so don't be so confident that you are over-calm about the economy."

Harvey points back to his yield curve model. (See bar chart) "Stocks do relatively poorly when the yield curve is inverted. They generally do well when the yield curve is positively sloped, as it is now. This is not just a U.S. phenomenon."

He concludes, "Getting the turning point in the economy right is incredibly important for an investment strategy. It is possible to turn economic adversity into opportunity."

Pictured below: Fuqua Professor Robert E. Whaley



CFOs See Recession Ending Second or Third Quarter 2002

Professor John R. Graham discusses FEI Survey.

At year-end 2001, Cam Harvey and I, in conjunction with Financial Executives International (FEI), surveyed 291 CFOs to find out how their companies were handling the recession and what they anticipate about the future. The majority of CFOs (65 percent) expect the recession to end in the second or third quarter of 2002, although they only expect GDP to grow by about one percent in 2002. Moreover, nearly one-third expects the recession to linger into the fourth quarter of 2002 or beyond.

This slow economic recovery has led Corporate America to take various belt-tightening measures: cuts in year-end bonuses (63 percent of companies reduced bonuses at year-end 2001), overtime (five percent reduction in 2002) and inventory (three percent reduction). When the economic picture does brighten sometime in 2002, companies might loosen their belts a bit—but not much. For example, companies plan to increase their number of employees, but the increase will only be one percent. Similarly, technology spending will increase by about 1.4 percent in 2002—but overall capital expenditures will decline by five percent.

The executives describe three economic factors as being particularly important to their companies in the near-term. When presented with a list of 12 economic factors, 38 percent of CFOs said that consumer spending will have the greatest impact on their firm in the coming six months. Another 23 percent said that global economic concerns were most important.

Finally, the interest rate environment is important. By historical standards, interest rates are currently very low. This has resulted in one-third of surveyed firms refinancing their borrowings at lower interest rates. One-third of firms have also borrowed additional funds. However, even with these low interest rates, 57 percent of companies say that credit markets are tight, so borrowing is difficult, compared to only 12 percent that say credit is easily available. Notably, 78 percent of high-technology firms say that credit is hard to come by.

BY JOHN GRAHAM