Navigate the double-dip with some vital economic rules of thumb

Why have the markets fallen now, in August 2011, and not June or November? Spotting when the markets will move is more than a simple matter of trend theory and experienced fund managers use several rules of thumb. These are good predictors of how the economy will behave.

Falling world markets

Many world market lows are currently way below their previous lows of the last two years. I always say, “Once the markets fall below all the previous lows across the ‘flat’, we’re entering the second dip.”

The articles we have been writing lately have predicted that come September 2011 the markets would fall – and now they have. Even the Australian market (which hasn’t been in recession for 20 years) and the first to open each day, has been falling dramatically. It dropped from a high of 5000 just after April to 4000 in August, in four months a drop of 20% to the same point in May-June 2009.

Using some rules of thumb

Back in the boom time of February 2007, we went to our clients and said “The world will be in a big recession by July.” Our rule of thumb at that time was housing. Specifically, how long it was taking to sell a home in the United States.

We said, “Once the time to sell goes over nine months, the rule of thumb says it’s highly probable the world will go into a recession.” By July 2007, the markets had started to fall away.

The next rule of thumb says, “What happens to the market will hit the economy six months later.” The markets are a lead economic indicator, but audiences were telling us we were crazy. Six months later, the market had fallen away and the recession had hit.

Market downs and ups

In February 2009 we told audiences, “Within a week or two the market will turn around.” The rule of thumb this time said, “It’s rare for markets to fall below their previous low.” In February 2009 we were 91% of the way down to the previous lows of some 5 years earlier. This suggested a high probability of the market turning any day. Within a week, on 6th March, this is exactly what happened.

We then said, “By September 2009, after two reporting periods, the market will peak out again.” People naturally asked, “By how much?” The rule of thumb says, “If the market drops 20%, it will go back up 20%.” In this case the market had dropped 50- 60% and so we told audiences, “The market will go back up by 50-60%.” Sure enough, it did.

Another rule of thumb says, “If the market falls by more than 50%, there’s every chance we’ll have a W-shaped, rather than a V-shaped, recovery.” The W-shaped recovery is not quite the same profile as its phonetic equivalent because it includes a flat line in the middle.

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Flat phase into second dip

The 1970s W-shaped recovery had a flat period post 1975. Looking historically, it suggested our flat period would have a similar two-year span. Starting this phase in September 2009, there was every chance we would finish the flat period in September 2011.

Looking beyond September 2011, we were already sure another dip was on its way by examining the raw data. In a recent article we said, “If you study the fundamental data underlying the economy, they’re all heading towards another dip.” For example, UK consumer spending patterns have already gone into double-dip, US housing is back in a second dip, some economies around the world are back in recession already.

18 month wash through

A further rule of thumb is the “wash through factor”, which says, “When you make an economic decision, it usually takes about 18 months to see the effect.” This 18 month wash through can be seen frequently in business. When a company opens a new branch or launches a new product line,

We used this old rule of thumb to good effect in my fund management days. If a corporate executive announced, “We’re going to launch the XYZ initiative,” I would simply add 18 months before expecting a tangible result.

September 2009 saw governments making various policy decisions. Add 18 months for the wash through effect. We started to see what was happening – or not – during the flat period. Reverting to the underlying raw data, it became apparent the policy decisions had not engendered positive signs of growth.

When governments around the world make decisions to plug the economic hole with spending and fiscal stimuli, wait 18 months for the wash through. It does not matter how much rhetoric is in the marketplace, if the underlying data are not positive, at some point you will see a falloff in the market.

Rules of thumb for recovery signs

Two key rules of thumb suggest when the recovery is well on track. In a previous article, we explained how commodity prices are one of the first signs of recovery. When they spike, it indicates demand from manufacturers because they have run out of stock. This manufacturing demand is normally an underlying stimulus to the economy.

The second important sign is when the markets fall away. Is the current low point below all previous low points across the flat period? Yes. This is where we are right now in several markets around the world. But we must remember this commentary is generic. World markets are quite disparate and Asia, for example, still has strong growth.

You would expect a six-month down period, in a typical double-dip, coming off the end of the flat phase. This dip is then likely to be followed by a period of economic recovery.

Why the double-dip now?

As we have described, the economy has followed the market rule of thumb perfectly. Secondly, September 2009 saw the peak after the market had climbed back up the curve. Add two years to the start of the flat phase in September 2009 and here we are.

But why August and not September for the second dip?

Every analyst is probably following these basic rules of thumb and therefore knows something is likely to happen in September 2011. Some punters will jump a month early and take early positions – this is August, others will wait for September post the vacation period. Many will want to take their position before anyone else. It is the result of this concerted action that we are witnessing right now.

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