



Anatomy of Equity Investments during a Recession - part 1

The current hot topic of discussion in the press, excluding the presidential elections, is the worldwide massive credit crunch that is expected to contribute to a likely recession in the U.S. economy. The FOMC has made an emergency 75 basis point (.75%) cut to the target Fed Funds rate and there is wide expectation that they will follow with another cut when they meet January 30. We typically do not make “economic” predictions or calls. Instead, our portfolio management decisions are driven from our investment research methods that take their cues from the market movements. With that said, the movement of the S&P 500 Index can be as good of a recession predictor as any other indicator. This Market Commentary will focus on the movements of the S&P 500 Index just prior to a recession, during a recession and after a recession. It is important to make sure that we review market behavior during times past when recessions occurred and draw some wisdom from that analysis.

Before presenting the research, let me first write briefly about the start to this year, which can be summed up quickly by reviewing Table 1 below. The equity markets have started 2008 worse than any other year in recorded history.

Description	From Top 10/31/07	YTD
Wilshire 5000 Index	-14.35%	-9.42%
Dow Jones Industrial Average	-12.37%	-7.97%
S&P 500 Dividend Adjusted Index	-13.74%	-9.26%
Russell 2000 CBOE Index	-16.84%	-10.11%
NASDAQ Composite Index	-18.64%	-12.29%

www.stockcharts.com

Table 1 – Data for the week ending January 25, 2008

Fortunately, our actively managed client portfolios have been defensively invested in money markets and earning a return every day. So far our investment discipline has worked perfectly in 2008. We will continue to monitor the equity market activity daily, as usual, patiently looking for an improved risk-adjusted return potential for re-entry.

Now let us move on to the details of this Market Commentary. There are many reasons to believe that we are either in, or headed to, an economic recession. History shows that investors should be very careful before and during recessions, but that some of the very best investments are made as the expectation for the recession to end prevails and the “growth” cycle of the economy begins anew. In our “active” investment discipline we attempt to navigate portfolios away from significant drawdown (drops) in equity markets and then back into equities when the risk-adjusted return potential improves. It is a valuable portfolio management discipline in these current market conditions.



Market Commentary

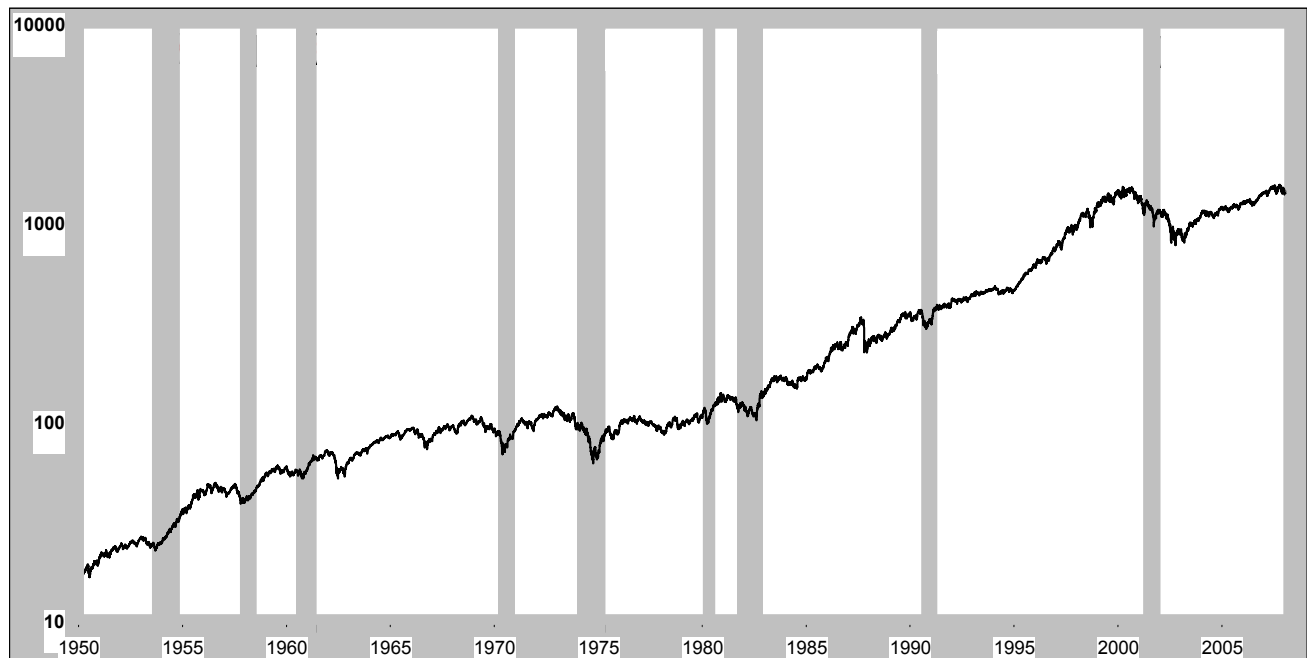
Which organization determines that an economic recession is occurring and what is the definition of an economic recession?

The National Bureau of Economic Research (NBER), located in Cambridge, Massachusetts and on the web at <http://www.nber.org/cycles/>, is the organization that determines when the economy is in a recession. Contrary to popular belief, the NBER does not define a recession in terms of two consecutive quarters of decline in real GDP. Rather, a recession is “a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales”. However, as is the case with so many other economic conditions, a recession is typically not officially determined until long after it has begun, normally as much as six to twelve months later, and sometimes not until after the recession has ended if the recession lasts only a short period of time.

Why is it important for investors to know that we are in a recession?

Recessions have consistently resulted in drops in equity markets. In the chart below the shaded periods represent times of economic recession. If you look closely you can see that the S&P 500 Index has declined leading up to and during periods of economic recession.

S&P 500 Index 1950 to 2008 with Economic Recessions shaded



www.finance.yahoo.com

Is the S&P 500 Index a leading indicator, giving warning in advance of recessions?

Reviewing only those shaded, recessionary periods in the chart above, the analysis becomes clear that the S&P 500 Index is also a leading indicator of predicting recessions. The leading / lagging properties of this index and how much it changes during a recession are presented in Table 2, using daily closing values of the S&P 500 Index. Many analysts use weekly closing values. We believe that approach is wrong because investor's portfolios are not priced week to week, but rather day to day.



Market Commentary

Business Cycle		Peak of S&P 500		Lead / Lag (+/-)	Trough of S&P 500		Lead / Lag (+/-)	S&P 500 % Change
Peak	Trough	Date	Level	Months	Date	Level	Months	Peak to Trough
Jul-53	May-54	Jan-53	26.66	+6	Sep-53	22.71	+8	-14.82%
Aug-57	Apr-58	Jul-57	49.13	+1	Dec-57	39.38	+4	-19.85%
Apr-60	Feb-61	Jan-60	60.39	+4	Oct-60	52.20	+4	-13.56%
Dec-69	Nov-70	May-69	106.16	+7	May-70	69.29	+5	-34.73%
Nov-73	Mar-75	Jan-73	120.24	+10	Dec-74	65.01	+3	-45.93%
Jan-80	Jul-80	Feb-80	118.44	-1	Mar-80	98.22	+3	-17.07%
Jul-81	Nov-82	Mar-81	137.11	+3	Aug-82	102.42	+6	-25.30%
Jul-90	Mar-91	Jul-90	368.95	+1	Oct-90	295.46	+5	-19.92%
Mar-01	Nov-01	Sep-00	1,520.77	+7	Sep-01	965.80	+2	-36.49%
		Oct-07	1,565.15	?	Jan-08	1,310.50	?	-16.27%

Table 2 – S&P 500 Index lead / lag on business cycle and % change

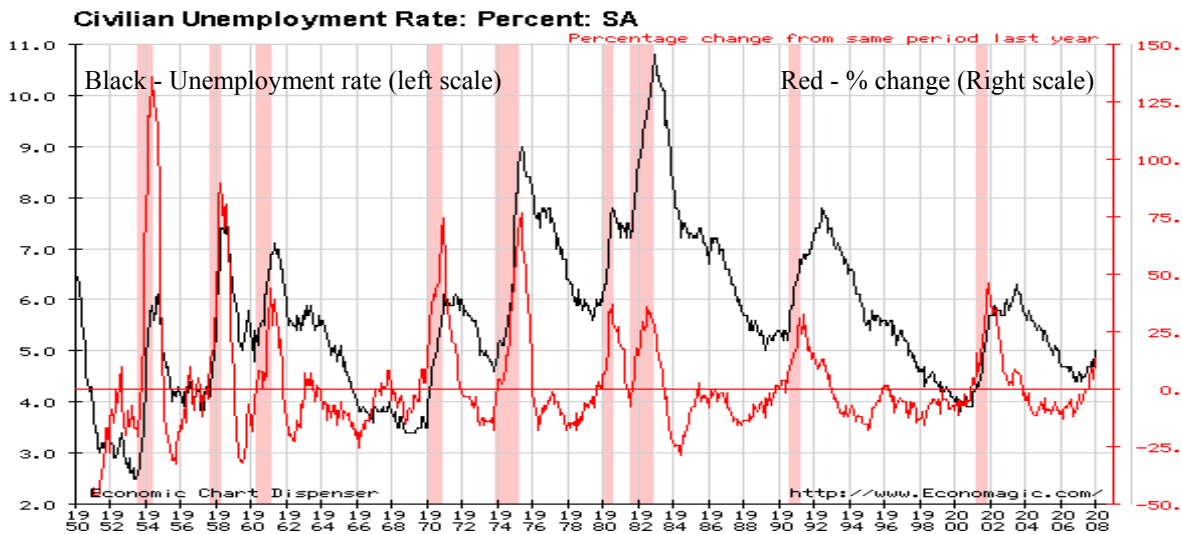
www.nber.com

From Table 2 above there are two major conclusions:

- (1) The S&P 500 Index is a very good leading indicator. Since the 1950s, the S&P 500 Index has always peaked before the peak of a business cycle, with only one exception (1980 business cycle). The S&P 500 Index establishes a trough prior to the end of a recession without exception.
- (2) The S&P 500 Index average decline is -24.39%, and the median decline is -19.85%, in recessions. Presently, the S&P 500 Index is down almost 14.0% from its peak in October 2007. If history is a guide, the S&P 500 Index is certainly indicating a potential recession.

Are we in a recession now?

It is important to understand the movements of the markets and the messages that they are sending. Clearly the decline in the equity markets since the peak in October is indicating that a recession may now be present. Of course anticipating this we have been defensively invested for many weeks now. But let us corroborate what the S&P 500 Index is saying by reviewing one of the economic activity measurements, unemployment. Please review the chart below which contains the historical unemployment rate and its relationship to recessions. Clearly you can see that the recent increase in unemployment is an ominous warning that we may be in or headed into a recession.





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What should equity investors do now?

Be very careful. For now money market returns look awesome compared to the returns of stocks. At Hanlon Investment Management we take advantage of the periods of declining stock prices to seek the shelter of money market investments. Of course we will be on the lookout for the risk to fall and the market potential to increase, and will make portfolio modifications accordingly. Now is certainly the time for active management – defensive, and ultimately offensive moves.

Part 2 of this Market Commentary, to be published later this week, will analyze the details of the S&P 500 Index movements in the last two recessions, 1990 and 2001, as well as review the detailed moves that we made in client portfolios during the last recession in 2001. Finally, in Part 3 of this Market Commentary, we will review high yield bond fund investing and management within our Managed Income and the bond portions of our Growth and Income and Balanced allocations during similar market environments. It is all germane and informative, especially so now.

Thank you,

Sean Hanlon, CFP®
CEO and CIO

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