Q&A: Are we headed for another recession?

August 15 2011, By Jenny Hall

Euros and American dollars. Credit: sxc.hu, lasop

A standoff in the U.S. over the debt ceiling. The possibility of more bailouts in Europe. Markets slumping almost everywhere. We spoke to Professor Eric Kirzner to get a sense of what's causing financial uncertainty in the market right now -- and how worried you should be. Kirzner is a professor of finance at the Rotman School of Management and he holds the John H. Watson Chair in Value Investing.

Do you think we're headed into a double dip recession?

No, I don't. Markets are pretty smart. They anticipate events in advance. Leading economic indicators generally move five to nine months ahead of the economy. Right now the markets are infused with all the uncertainty out there, but I'm not seeing that they're anticipating recession.

For a double dip recession we're talking about economic contraction and rising unemployment. Right now we have very low interest rates, unemployment high but not increasing, and corporate profits still coming in at a fairly healthy level. These indicate that we're likely to see a pretty slow economy for the next period of time, but they do not add up to economic contraction.

You mentioned an infusion of uncertainty in the markets. How important is the debt ceiling crisis in the U.S. and the debt crisis in Europe?

The U.S. situation is less important than the European one. In the U.S. you've got a lot of politicking. This debt ceiling thing has come up something like 25 times over the past number of years. This time it took a different form because you have this right wing group—the Tea Party—that that is trying to wield some power. In my view, they held the country hostage up until the last minute. There are still a lot of things to sort out in terms of where the cuts are going to take place, but to me, the U.S. raising the debt ceiling is business as usual.

The European situation is much worse. We're dealing with a lot of uncertainty. We know about the problems in Spain and Italy and Greece. We're starting to see other emerging problems, such as in France. There's a point at which Germany, which is the powerhouse, may not want to foot the bill for bailouts. I think it's raising questions about whether the Euro zone can even survive—certainly in its current format, or even at all.

In Europe, we have countries suffering from high unemployment. They don't have control over their currency and they don't have a lot of control over monetary policy. The notion is that maybe migration will take place, that maybe people will move from high unemployment countries to more robust countries. But cultural differences are strong in Europe. If you wake up one morning in Spain and say, "I can't get a job," do you actually move to Germany? I'm not so sure.

I think that the European debt crisis is the real issue today and that's what I think is fueling the volatility in the markets.

We've talked a lot about uncertainty. To a layperson reading or listening to market analysis, it sometimes seems like we're talking about the flu, like panic is contagious.

Psychology is a major factor. When the markets are fluctuating, we're talking about changes in prices. What causes changing prices? Changing outlooks.

Say I wake up one morning and do an analysis and I say, "I don't think General Electric is worth $19 a share anymore. I think it's worth $15." If I've done a sound analysis, that's legitimate, that's not emotional.

It's another thing to wake up and say, "I don't know what's going on in the world. I'm getting really nervous and I don't know if I'm going to lose my retirement savings. Therefore, I don't want to pay this price for General Electric. In fact, I want to sell it, not because I think it's worth $19 per share, but because I'm frightened of the whole market."

You've got waves of pessimism and optimism that sweep over markets from time to time and those can drive prices in the short run.

And this is the case even when we're not talking about stocks or investment vehicles that have anything materially to do with Europe?

Yes. Clearly the situation shouldn't be such that one day we believe the market is worth 500 points more than the next day. We've had four straight days of 500 point moves. These are huge moves, which means that right now market is being driven by greed and fear. Of course there's something underlying it—uncertainty about events in the U.S. and Europe. But the extent of these extremes reflects emotion rather than reality.

I was talking to investment groups the other day and I said, "I'm sure a lot of you wake up in the morning and you're frightened and you want to sell. Then maybe you see that prices have already fallen 20 per cent, and you wonder if you should be buying." When you get both emotions hitting you at the same time—greed and fear—it is probably time to do nothing.

So what should the average investor be doing?

The question is, when do you make changes? There is a psychological reason for making a change. One is you discover that the last couple of weeks have been so disturbing to you that you haven't slept at night and it's affected your job and relationships. That means you've got too much risk in your portfolio and you've got to make a change.

The other time you would make changes is if your financial circumstances have changed—you've had a windfall or your portfolio has performed better than expected. Then taking some risk off the table would make good practical sense. Or maybe things have gone worse than expected and your goals are becoming more elusive. Then you might have to add a little bit more risk to your portfolio.

You should be making changes when your circumstances or your objectives or your risk tolerances change. You should not be making changes on the basis of current events. It's impossible. It's absolutely impossible to make good, rational decisions when markets are gyrating the way they are.

Resisting making changes in response to current events assumes you start with a sound investment strategy to start with, doesn't it?

Yes, you have to start with a sound investment strategy. Over the years I've certainly run into a lot of people who don't have one.

A sound investment strategy is knowing yourself, setting your objectives, understanding your risk tolerances, knowing your investment horizon, and then setting what's called an asset allocation that's designed to meet those objectives.

Provided by University of Toronto

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