



Doctor Doom

The Worst Is Yet To Come

Nouriel Roubini, 01.22.09, 12:01 AM ET

I have been predicting for a while that the most recent bear market sucker's rally would lose its steam and, like the previous bear market rallies in the last 18 months, U.S. and global equities prices would head again toward new lows. Here's why.

As [my work](#) and the work of [our research team at RGE Monitor](#) predicts (we will publish, later this week, our 2009 Global Economic Outlook, a 75-page research piece for our clients), this will be the worst U.S. recession in the last 50 years--and the worst synchronized global recession in decades.

For a few weeks since late November, equity markets ignored the onslaught of much-worse-than-expected macro news (and all the news was really worse than awful) and had a nice 25% bear market sucker's rally. But the drumbeat of worse-than-expected macro news--and earnings news, and financial news--has finally taken a toll on the delusional market belief that the worst was over for financial markets and for equity markets and that the U.S. and global economy would recover in the second half of 2009. So equity prices have already reversed more than half of their most recent bear market rally as the lousy macro news has finally shocked the wishful thinkers.

Indeed, the retail sales figures just published confirmed that a shopped-out, savings-less and debt-burdened U.S. consumer is now faltering as job losses, income losses, falls in home wealth, falls in equity wealth, high and rising debt and debt-servicing ratios and a severe credit crunch take a severe toll on the ability of consumers to spend. And reduction in spending and deleveraging of the U.S. consumer will take years to rebuild the savings rate of a household sector now hit by a severe shock to its net worth (as equity and home values fall while debts have been rising), and shocked in its inability to generate income as job losses mount and the unemployment rate surges.

Our research at RGE Monitor suggests that the U.S. and global recession will continue at least until Q4 2009 (a nasty, 24-month, U-shaped recession) and that the recovery in 2010-'11 will be very weak, with growth around 1%--well below a potential of 2.75%. And we cannot rule out that a more severe L-shaped stag-deflation (as in Japan in the 1990s) will take hold. Indeed, as I have argued, while the odds of a systemic financial meltdown have been reduced by the actions of the Group of Seven and other economies, severe vulnerabilities remain.

The credit crunch will persist and spread beyond mortgages. Deleveraging will continue, as thousands of hedge funds--many of which will go bust--and other leveraged players are forced to sell assets into illiquid and distressed markets, causing price declines and driving more insolvent financial institutions out of business. Credit losses will mount as the recession deepens, and a few emerging-market economies will certainly experience full-blown financial crisis.

So 2009 will be a painful year of global recession and further financial stresses, losses and bankruptcies. Currently, the probability of an L-shaped, stag-deflation is now rising to one-third, while the probability of a severe U-shaped recession is two-thirds. Only aggressive, coordinated and effective policy action by both advanced and emerging-market countries can ensure the global economy starts to recover, however slowly, in 2010, rather than entering a more protracted period of economic stagnation.

So while our benchmark scenarios see a severe U-shaped global recession with very weak growth recovery in 2010, we cannot exclude the possibility of a worse outcome--i.e. an L-shaped recession that, in our view, has at least a one-third probability. So the worst is ahead of us rather than behind us, both for the real economy and for financial markets.

With my forecast of 2009 earnings per share for S&P 500 firms being in the \$50 to \$60 range, and with price-earnings ratios likely to be in the 10 to 12 range, given a severe global recession, the S&P 500 could bottom at some point in 2009, at best at a level of 720 and, in a worse scenario, as low as 500 or 600.

So, the worst is indeed still ahead of us.

Nouriel Roubini, a professor at the Stern Business School at [New York University](#) and chairman of [Roubini Global Economics](#), is a weekly columnist for [Forbes.com](#). Analysts at Roubini Global Economics assisted in research for this week's column.