Will the Asset Market Performance of 2007 be an Extension of 2006?

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The year 2006 was a wonderful year for asset markets around the world. In Latin America the Venezuelan stock market rose by 143% and Peru by 169%. In Europe the Spanish stock market shone and surged more than 32%, while in the East, both the Shenzhen and Shanghai stock markets increased by more than 100%, India by 45%, Jakarta by 53%, Russia by 66% and Vietnam by 145% (see Figure 1).

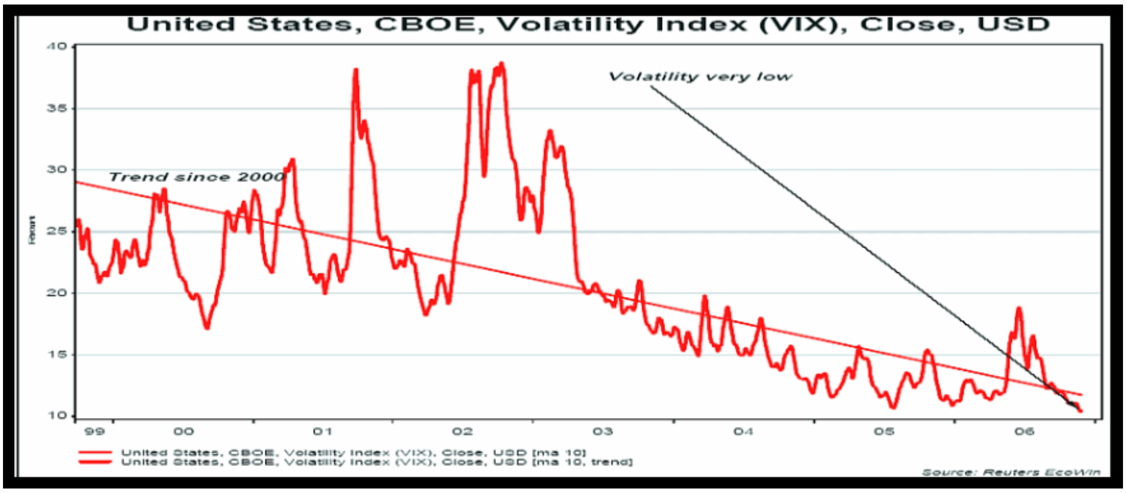
Figure 1: Vietnam Stock Exchange Index, 2001 - 2006

Source: Dragon Capital

In the US, the S&P 500 increased by 16% in dollar terms, but only by 5% in Euro terms. The NASADAQ increased by 9% but lost 4% of its value in Euro terms.

The year 2006 was also characterized by a further decline in volatility to a 15-years low (see Figure 2).

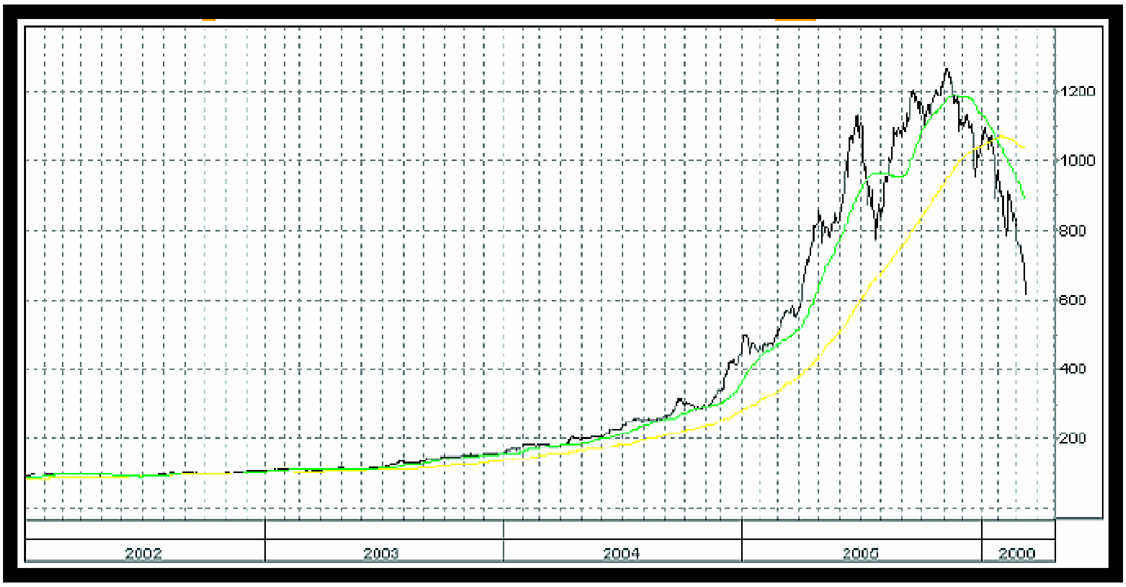
Figure 2: US Volatility Index (VIX), 1999 -2006



Source: Bridgewater Associates

And although volatility increased sharply in the April/May decline, noteworthy is that, as Jim Bianco pointed out, the S&P 500 has not experienced a 2% correction since July 13, 2006, when the latest rally got underway. This string of 162 actual days (114 trading days) is the second longest rallying period without a 2% correction since 1964 (only in 1995 did we have a longer period without a 2% correction (153 trading days). The advance since October 2002 is the fourth longest on record but it has not been particularly strong in terms of percentage gain. In addition, we need to compare the current advance to other asset price increases. In comparison to the performance of foreign stock markets the S&P 500 advance has been disappointing. Even worse has been the performance of all US financial assets including stocks, bonds, and cash compared to commodities over the last few years. Even in 2006, when the energy complex performed poorly and dragged down the performance of the CRB Index to minus 5%, several commodities shone. Nickel prices increased by 152%, Corn was up 80%, Orange Juice 59%, Wheat 49%, Silver 45%, Copper (despite its recent weakness) 33%, aluminum 25%, and gold 22%. The big losers of 2006 were natural gas (minus 44%), sugar (minus 19%), and gasoline (minus 8%). Among financial assets, the major losers were the Middle Eastern stock markets, which declined by about 50% (see Figure 3) and in Japan the Nikkei, which only rose by 7% in Yen terms but declined by 4% in Euro terms.

Figure 3: Dubai – United Emirates Stock Market Index, 2002 - 2006

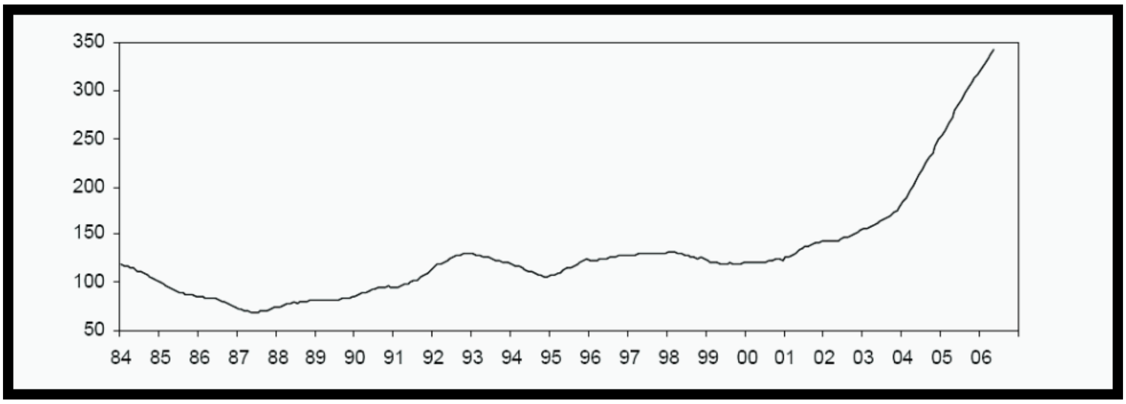


Source: Bloomberg

What is surprising about 2006 is that despite only minor hiccups in asset markets, a surprisingly large number of investment funds didn't perform well. Amaranth went under; Goldman Sachs' flagship hedge fund, Global Alpha Fund, with US$10 billion in assets, dropped through the end of November by over 11% in value; John Henry's US$ 1.25 billion Strategic Allocation Program had lost 12.5% by mid- December; and the US$ 195 million Dollar Program, his biggest fund dedicated to currencies, had fallen 34%. At the same time, the US$ 70 billion managed by Commodity Trading Advisors (CTA) returned just 1.4% on average in 2006, while Henry Kravis and Leon Black's publicly traded LBO funds declined by 7.5% since they went public. Shares in KKR's Private Equity Investors LP, which trade in Amsterdam, declined by 12% since its IPO in May 2006. This is significant because if leveraged pools of funds perform poorly, investors will in time withdraw their funds. This would likely lead to de-leveraging and could, in some cases where trades were crowded, bring about sharp downward market movements and far higher volatility (see Figure 2 and also below).

"Excess Liquidity" has become a buzz word in the investment community and there is little doubt that excessive money supply and debt growth in the US which lead to a US$ 800 billion US current account deficit is largely responsible for too much money chasing too few assets around the world. However, we should not overlook the possibility that excess liquidity can vanish rather rapidly. How so? In the case of the Middle Eastern oil producers liquidity began to shrink for three principal reasons. When stock markets turned down in late 2005, marginal and highly leveraged investors had to sell equities in order to meet margin calls. This pushed prices lower and triggered further margin calls, which pushed prices even lower. Then, the stock market boom was also accompanied by a huge real estate boom. Condos and houses were bought off plans and as construction progressed, the buyers had to meet the payments for their properties. This drained money from the financial market into the real economy and put additional pressure on equities, which were then liquidated to meet the installments for the purchased properties. At the same time, the OPEC countries went on a spending binge and imported an increasing quantity of goods and services (see Figure 4).

Figure 4: OPEC Imports in billion of Dollars (annual rate), 1984 - 2006

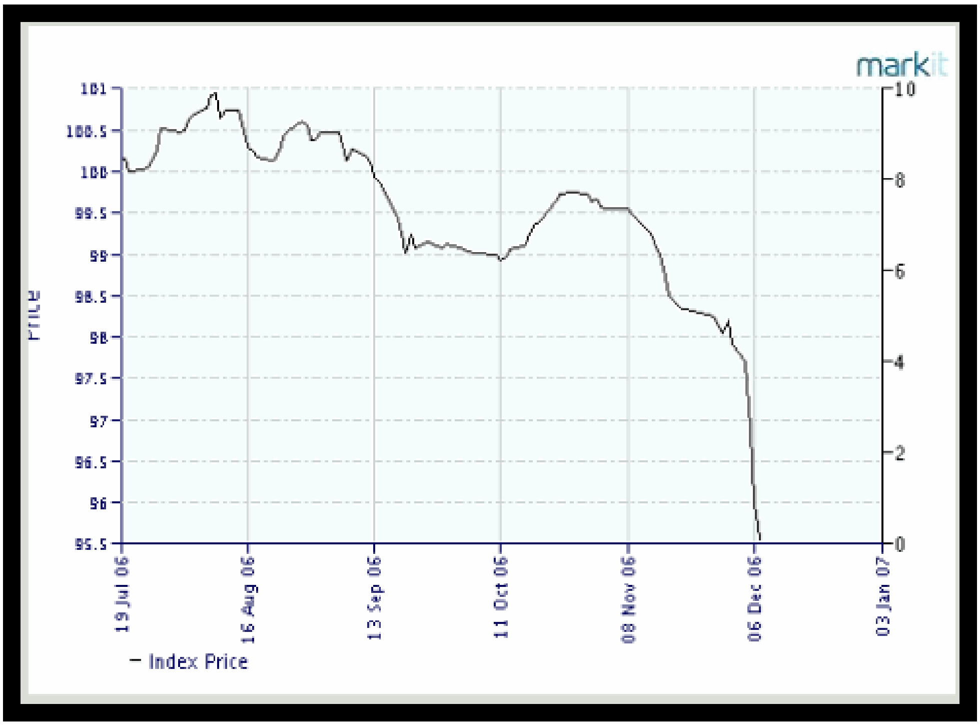


Source: Bridgewater Associates

Because after late 2005 oil prices and oil production no longer increased and OPEC revenues leveled off, a more than doubling of imports to an annual rate of close to US$ 350 billion since 2004 meant that the OPEC governments' surpluses diminished rapidly and led to overall tighter liquidity in the system. I am mentioning the Middle Eastern experience for several reasons.

Rising asset markets always lead to increased liquidity because it allows the speculators to leverage up – that is as asset prices increase the loan value of these assets also increases, and additional loans can be obtained against the rising asset values. Conversely when asset prices decline (and we had a taste of it in the April/May 2006 sell-off), leveraged positions are reduced, liquidity immediately shrinks, and volatility increases. Therefore, I believe that the pundits who are looking at signs from the real economy of money becoming tighter, which will in turn bring down asset markets, will be disappointed. It is the asset markets, which when they begin to decline will provide the first sign of excess liquidity shrinking. In the US, we have the first symptom of liquidity getting tighter in the real estate market. From Figure 5, we can see that the value of sub-prime loans has recently collapsed (see Figure 5).

Figure 5: Price Index of BBB rated Sub-prime Loans, 2006



Source: www.markitcom.com

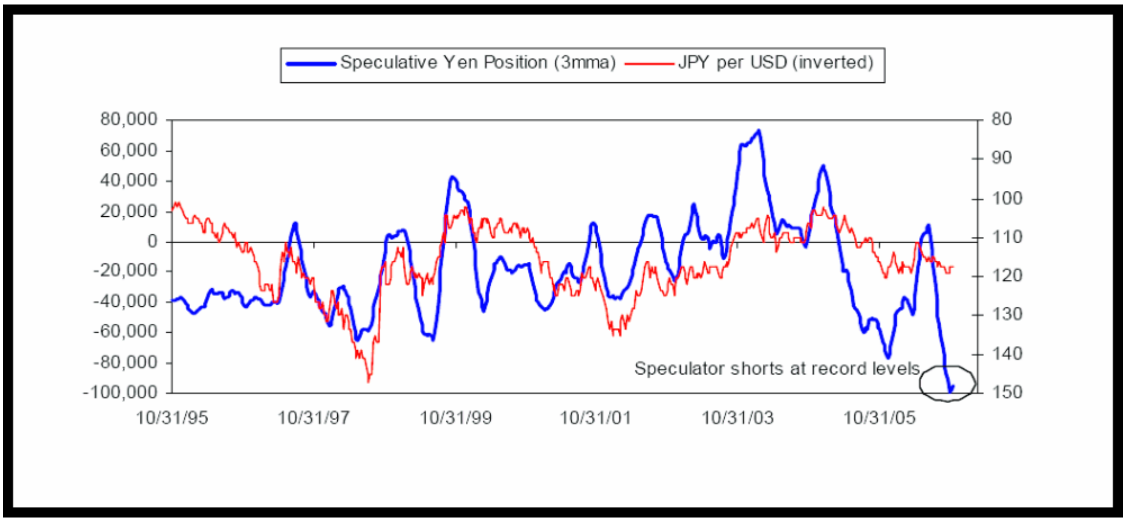
A second symptom of tighter liquidity is evident from a slowdown in debt growth among US households. So, whereas there is plenty of liquidity among the Wall Street asset shufflers, the median US household seems to be struggling from home prices which are no longer increasing. According to Kurt Richebächer, net borrowings by American households declined in the third quarter of 2006 to an annualized rate of US$ 842 billion from an annualized rate of US$ 1.1 trillion in the second quarter of 2006 and a peak of US$ 1.33 trillion in the fourth quarter of 2005. In the meantime, net mortgage borrowings fell in the third quarter to US$ 673 billion from US$ 1.22 trillion in the third quarter of 2005. As a result, total household and mortgage annualized debt growth declined to 6.8% and 7.2% quarter-over quarter in 3Q06, the slowest pace in eight years. By itself a slowdown in household borrowings does not imply a decline in asset markets because a lower rate of debt growth by households can be offset by higher corporate borrowings and higher leverage of the asset shufflers who believe that low volatility is here to stay. However, it indicates an increasingly fragile financial house of cards, which is vulnerable to a shock from wherever it may come (see Figure 6).

Figure 6: Nikkei Index Compared to MSCI World Index

Source: www.credit-suisse.com/techresearch

One potential source of trouble could arise from the famous "Yen carry trade". Should this source of excess liquidity dry up, unpleasant consequences would undoubtedly follow! In my opinion, there is only one condition that could lead to a brutal unwinding of the carry trade and in the process also strengthen the Japanese Yen (see Figure 7)

Figure 7: Speculative Short Yen Positions, 1995 - 2006

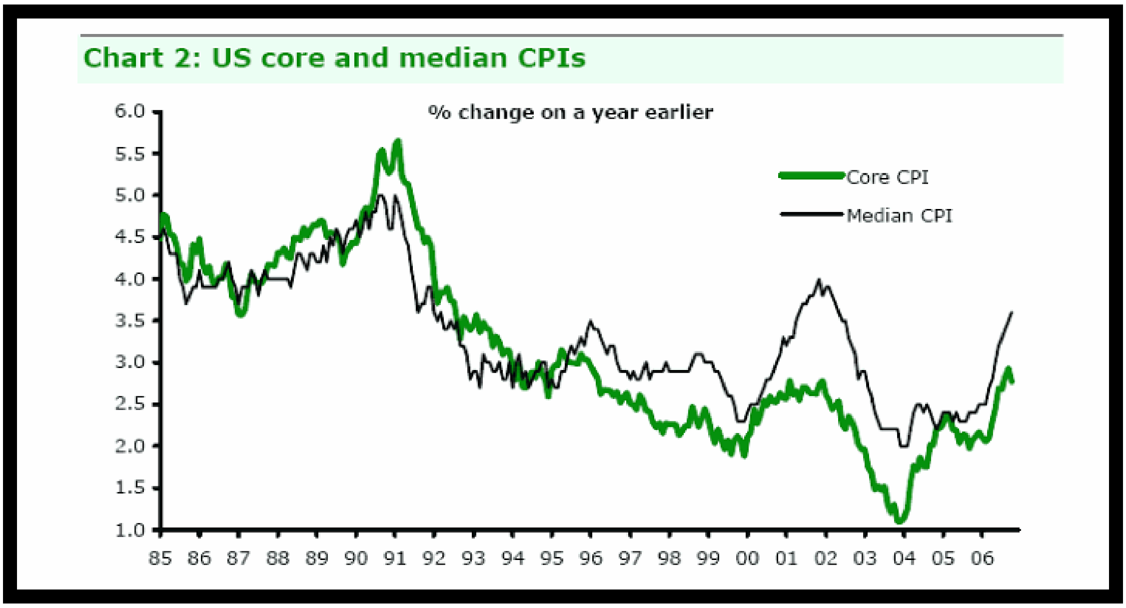


Source: Bridgewater Associates

If Japanese equities began to out-perform foreign assets, Japanese domestic financial institutions and individual investors would close out their overseas investment positions from which they gained in 2006 compared to Japanese investments in stocks and bonds. An out-performance of Japanese assets compared to the rest of the world could also come about as a result of foreign investments in real estate, stocks and bonds declining more than the borrowing cost in Japanese Yen. Again we are back to the point I made earlier whereby liquidity will dry up once asset markets no longer rise and reverse to the downside. Such an event would lead to a reduction in leverage and kill the Yen carry trade with a vengeance. I am aware that the investment community watches the Bank of Japan's interest rate policy like a hawk and assumes that an increase in Japanese interest rates would cause the end of the carry trade. However, by how much will the Bank of Japan increase interest rates? Unless it takes a very drastic action, and this is not likely, the carry trade will not be unwound because of an increase in Japanese interest rates.

Much more likely is the following scenario. The illiquidity of the US household sector, to which I alluded above, results in pronounced weakness of the US economy. As a result, the Fed cuts interest rates in order to stimulate the economy despite a clear tendency for inflation to accelerate (see Figure 8). As a consequence the US bond market tanks; a major part of the carry trade ends (borrowing Yen and investing in US bonds); the US dollar weakens especially against the Chinese Yuan and the Yen; volatility soars and some hedge funds are forced to cut their leveraged positions and a rout in asset markets follows.

Figure 8: US Core and Median Consumer Price Indices, 1985 - 2006



Source: ABN-AMRO

From the above, I suppose that my readers should consider myself as rather negative about the outlook for asset markets in 2007. I have been in the investment business since 1970 and I have never found so much unanimous bullishness about asset markets as I observe today. In the 1970s, investors were largely bearish about US stocks and bonds and the US dollar. In the 1980s sentiment turned extremely negative toward commodities and Latin America, which went through a terrific inflationary depression. In the early 1990s, investors grew disenchanted with the Japanese stock market and were extremely bearish about the outlook of Eastern Europe and Russia. And commodities were not even a subject of discussion! After the 1997 Asian crisis, hardly anyone wanted to touch emerging market equities. But now, everybody is positive about at least one asset class and thinks that the quite sensational performance of the last few years will continue forever.

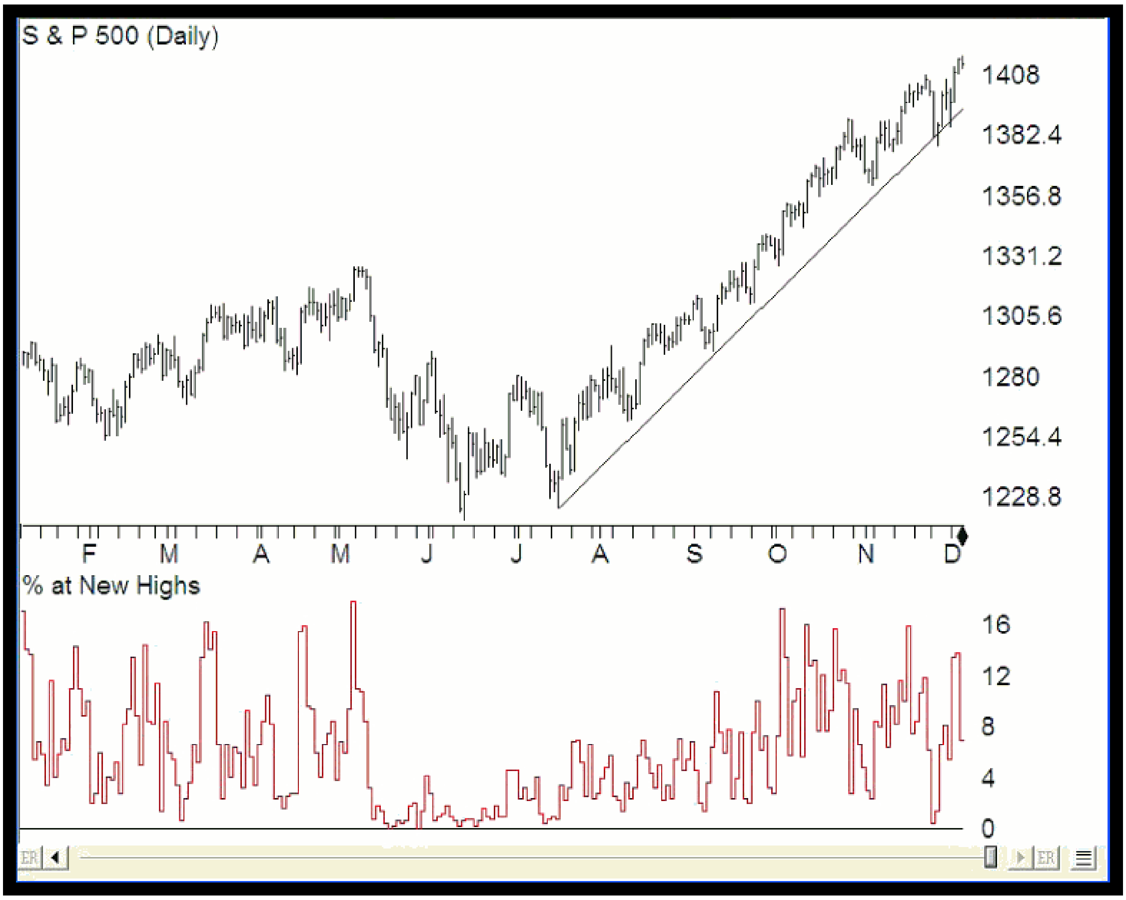
One concern I have is that US bond yields have been increasing since early December despite signs of weaker economic growth (see Figure 9).

Figure 9: US 30-Year Treasury Bond Yield, 2006

Source: www.decisionpoint.com

And as I mentioned above, if the Fed cuts interest rates, bond yields may well continue to increase as investors in US bonds – mostly foreigners – lose confidence in the Fed determination to keep inflation down. Then, as we pointed out in earlier reports, the economically sensitive Dow Jones Transportation Average has failed to confirm the new high in the Dow Jones Industrial. Also, there has recently been deterioration in several technical indicators. Moreover, the advance in the US market has narrowed which is evident from the fact that the percentage of stocks hitting new highs has been in a declining trend since October (see Figure 10).

Figure 10: Percent of Stocks at New Highs, 2006



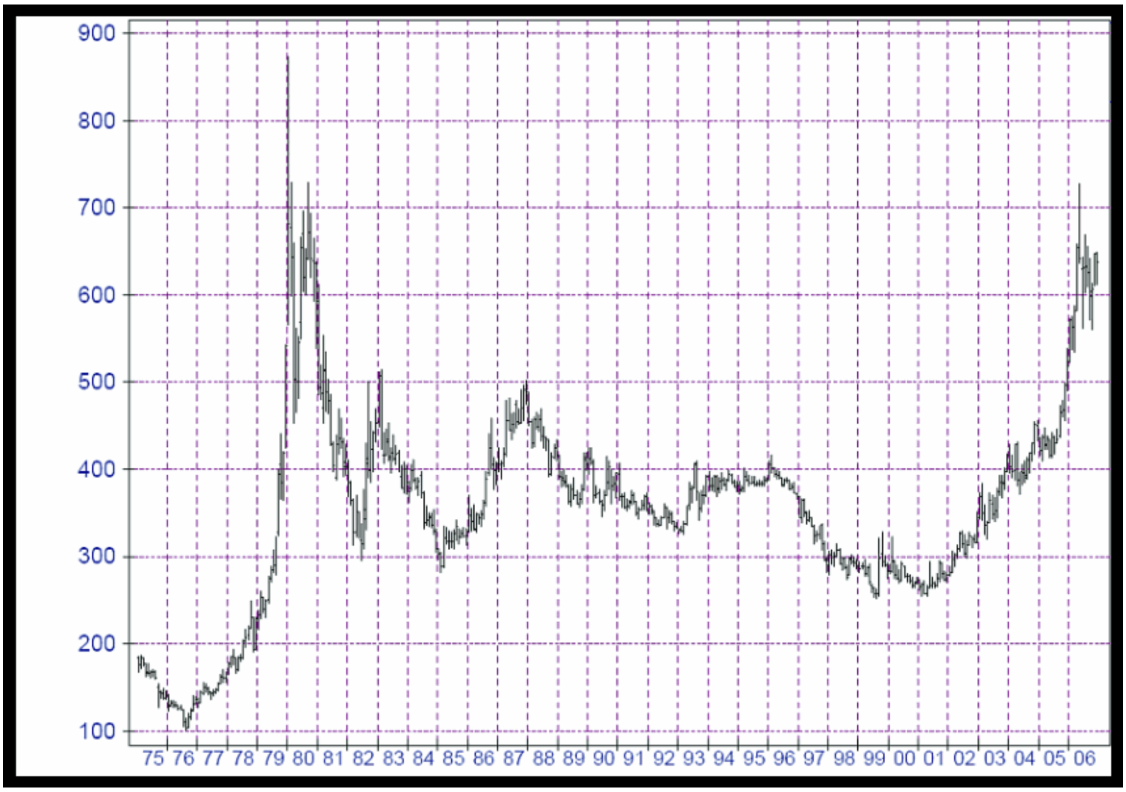
Source: David Vomund

In addition, the NASDAQ 100 Index has recently been weaker than the Dow Jones and since it led the advance since July 2006, I consider the recent under-performance to be significant.

So, whereas I am near term negative about US financial assets, I think that emerging markets could continue to rise for another two to three weeks but I would suggest investors to use any further strength to take profits.

If, however, my readers strongly disagree with my near term negative stance about asset markets, I would suggest buying gold. The only way asset markets will keep on rising is if the Fed massively “prints money” and allows debts to expand at an even higher rate than in the recent past. In such a case, gold is bound to continue to out-perform US financial assets. As can be seen from Figure 11, gold established a massive saucer bottom between 1995 and 2003, and while a decline to around US$ 450 should not be ruled out, I should think that if gold indeed declined to US$450, other asset markets – especially the sub-prime lending market – would probably cease to exist.

Figure 11: Gold Prices, 1975 - 2006



Source: Moore Research Center

Also, if asset markets continue to move up, I would imagine that the Thai stock market should recover quite strongly. Rather than to buy individual stocks, investors wishing to invest in Thailand should consider an investment in the Tonpoh Fund (minimum investment US$ 100,000 – see www.tonpoh.com).

Since I personally expect at some point in 2007 volatility to increase significantly, the question is how to play higher volatility best. Probably one of the cheapest ways to play higher volatility would be to purchase long dated calls on the Japanese Yen because higher volatility is likely to lead to a sharp reversal of short Yen positions. The last time when Yen short positions were almost as large as now was in 1998 (see Figure 7). And what happened thereafter? A huge surge in volatility and in the value of the Yen against the US dollar!