Bubbles, Bubbles on the Wall, Which is the Biggest of Them All?

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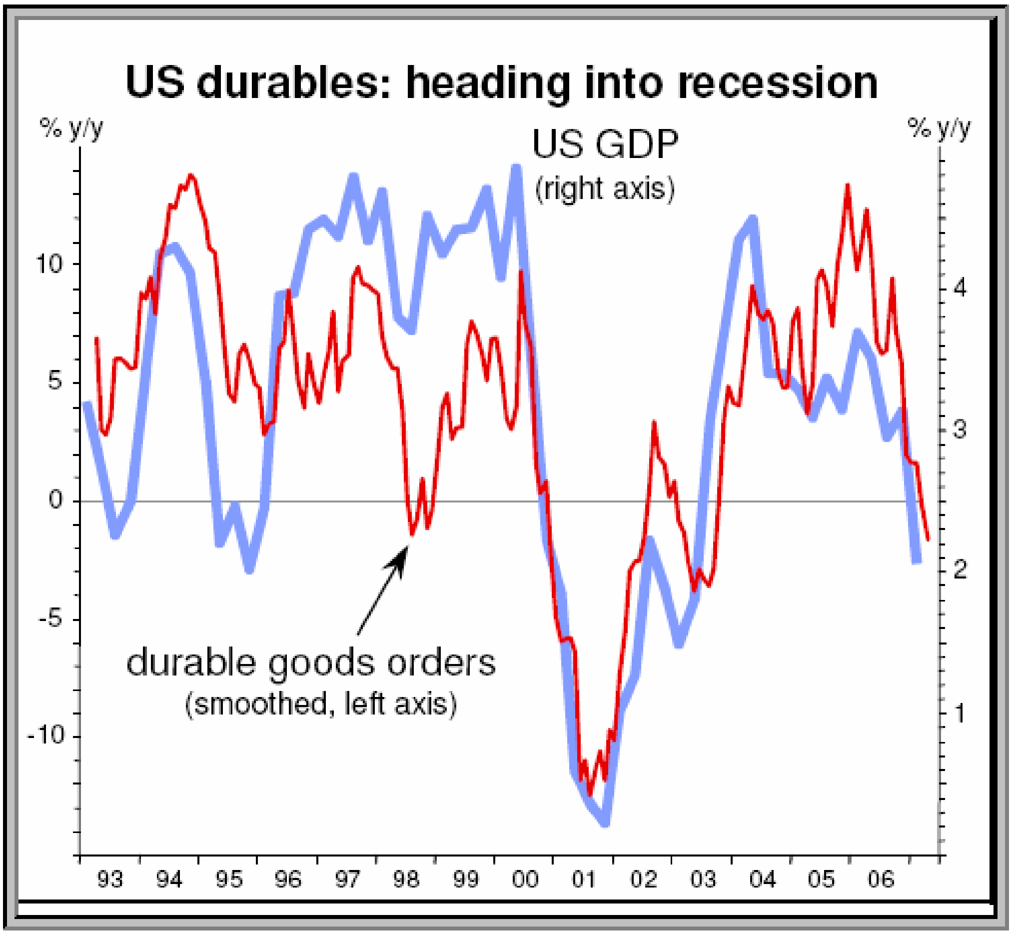
Irrespective whether one looks at equities, commodities, real estate, art, any kind of useless collectibles or bonds anywhere in the world, prices have soared over the last few years. We are truly in an asset bubble of unprecedented proportions and that these bubbles will eventually end badly should be clear. Usually, bull markets end with fewer and fewer stocks advancing (the 1970 – 1989 Japanese bull market ended with just bank stocks rising, and the US equity bull market, which ended in March 2000, was driven at the end by just a few TMT stocks). Therefore, when one or several bubbles begin to deflate the "Warning" is on the wall (see Figure 1).

Figure 1: Interest Rates are Rising!

Source: www.decisionpoint.com

In fact, the first bubble which recently popped was the US housing market in the summer of 2006 (although shares of homebuilders already peaked in the summer of 2005). Now, the bond market bubble seems also to have run into some strong headwind. Although the US economy has very clearly slowed down considerably, bonds are not rallying but declining as rates on 30-year US treasuries have risen since December 2006 from 4.5% to over 5%. According to David Rosenberg, beginning with last year's second quarter, the sequential pattern of GDP growth look like this: 2.6%, 2.0%. 2.5%, 0.6% and 1.9%. "In other words, a string of five quarters of below 3% growth, which has only happened 12 other times in the past 60 years or a trend we have seen less than 10% in the past". But, as I indicated in an earlier report, if inflation was properly accounted for the US would already be in a stagflationary recession (see Figure 2).

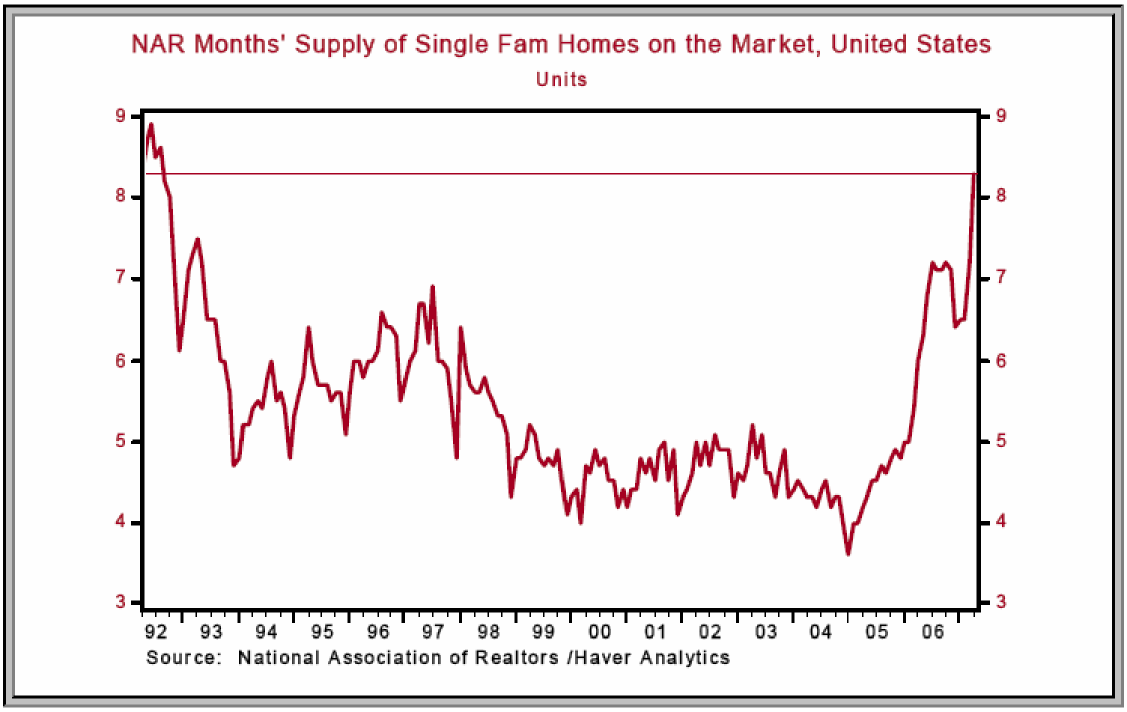
Figure 2: Weak Durable Goods Orders



Source: Robin Aspinall, Haskin Services Ltd

It is not only durable goods orders which are weak, housing also continues to deteriorate and employment is likely to be far weaker than what the official statistics show (see below). It is true that total new home sales surged 16.2% month-on-month in April to 981,000 units at an annual rate, but median new home prices declined 10.9% year-on-year, which is the worst deflation in home prices since the 1970 recession. According to David Rosenberg of Merrill Lynch, what might have happened is that the builders cleared out their inventories by cutting aggressively their prices after they found that there were no bids in the first five months of the year. In addition, something rather unusual occurred. From Figure 3, we can see that the existing housing inventory is at a 15-years' high (see Figure 3).

Figure 3: Unsold Existing Housing Inventories, 1992 - 2007



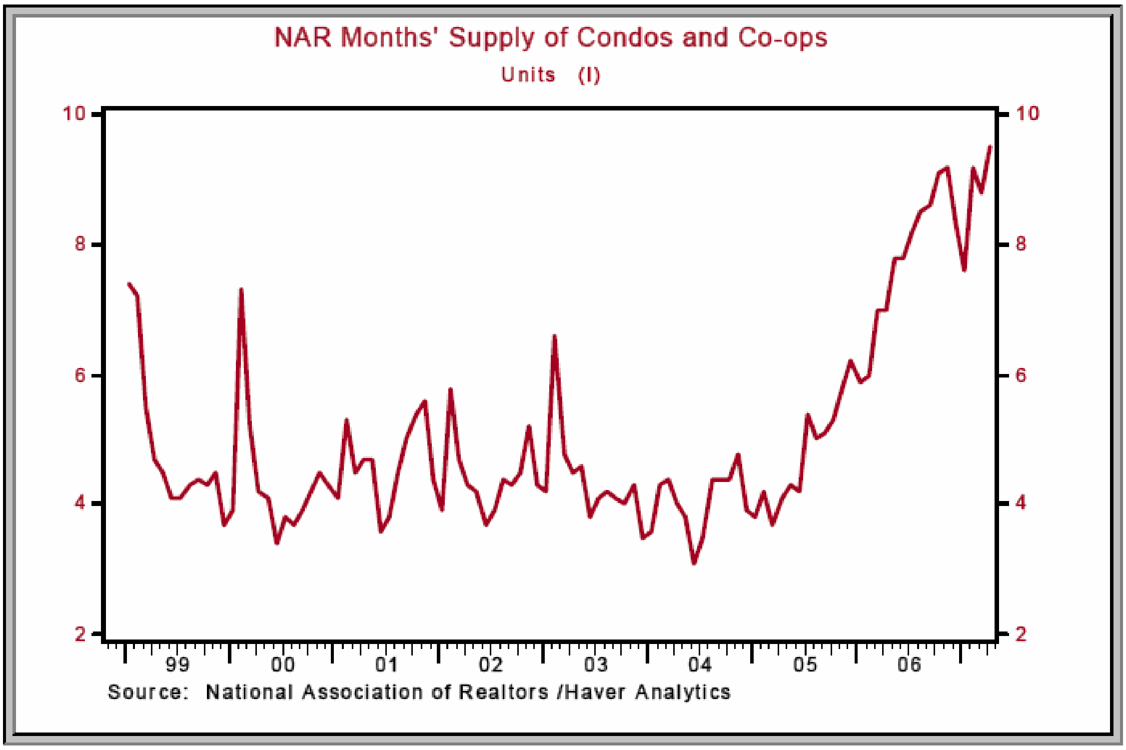
Source: David Rosenberg, Merrill Lynch

So, given the large inventory overhang it is puzzling that new home sales "were largely concentrated in 'units not started', which is code for pre-selling. This segment of the market saw a 35% surge, which was the largest for any April on record (data back to 1963). Sales of completed units barely budged – to 31,000 from 30,000 on the month”. Rosenberg rightly asks, “why anyone would be buying on spec when there is such a glut of inventory out there for free-standing completed units – still near a record high of 175,000 units (not annualized) and up 33% year-on-year”?

But it gets even more puzzling when we look at the April data for “Existing Home Sales”, which dropped 2.6% month-on-month and took the level below 6 million units at an annual rate for the first time in four years. This followed a 7.9% plunge in March and marked according to Rosenberg, “the weakest back-to-back performance ever recorded”.

Moreover, whereas the new home sales data showed that new sales soared in the two most stretched areas of the country – the South (+28% - mostly Florida) and West (+8.5% - mostly California), the existing home sales report showed that activity faltered badly in these two regions – -1.2% and -1.7% respectively. I may add that the inventories of unsold condos are at even higher levels (see Figure 4).

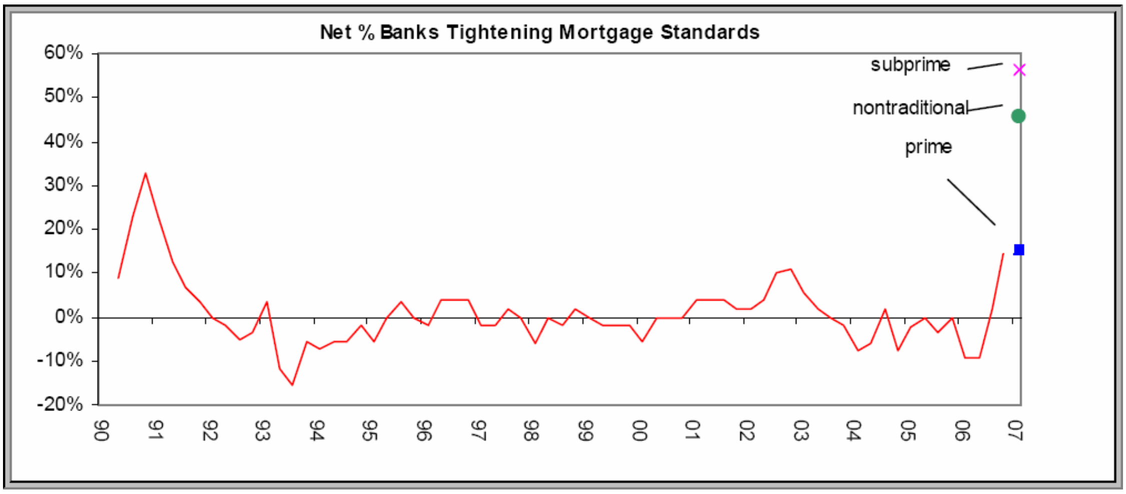
Figure 4: Condo Inventories at an all Time High



Source: David Rosenberg, Merrill Lynch

From Figure 4, we can see that the supply of condos increased from less than 4 months in 2004, to 7 months a year ago, and now to close to 10 months! Since lending standards for mortgages have been tightened considerably (see Figure 5) an early recovery in housing is, in my opinion, at least for now just wishful thinking.

Figure 5: Tighter Lending Standards for Mortgages

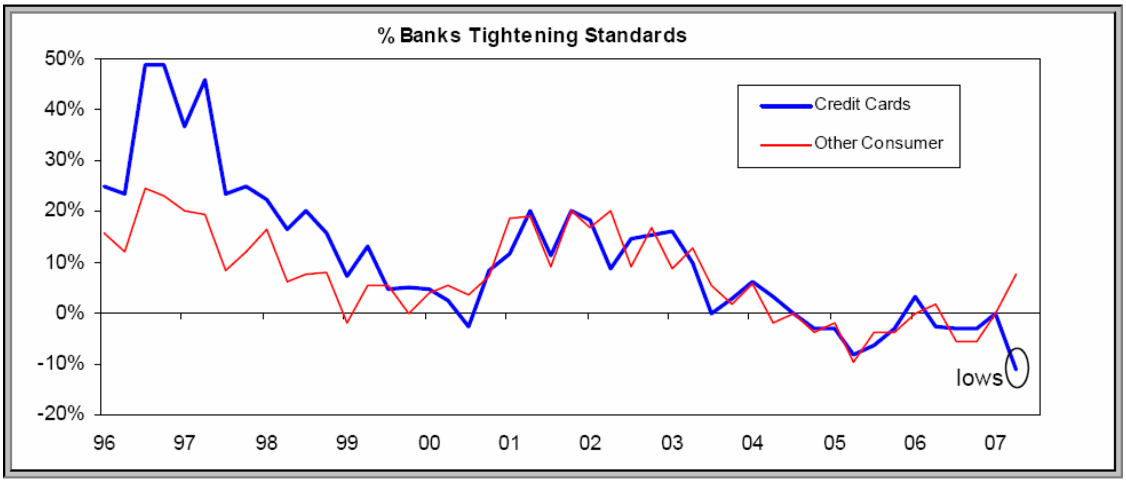


Source: Bridgewater Associates

I started out this report by arguing that as the global bull market in asset prices would end with fewer and fewer asset classes still increasing in value while one asset class after the other would roll over. So far, we had US housing rolling over as well as more recently bonds around the world (see Figure 1). But what about the next bubble to pop? I have explained before that in today's liquidity driven environment (well understood courtesy of the Fed) US asset prices – in particular the housing and stock markets – are the primary engine of growth for the US consumer. It's now, how assets drive the economy and not how the economy drives asset prices. Even Mr. Greenspan, the chief architect of the global asset bubble admitted two years ago that, "the determination of global economic activity in recent years has been influenced importantly by capital gains on various types of assets, and the liabilities that finance them. **Our forecasts and hence policy are becoming increasingly driven by asset price changes** "(emphasis added).

Therefore, it is likely that the next bubble to burst could be excessive US consumption, which would obviously have dire consequences for the entire economy and specifically for retailers and other consumer related discretionary spending sectors. In this respect the following should be of interest. Same-store sales were down 2.4% year-over-year in April, according to the International Council of Shopping Centers — the biggest drop since the trade-group began tracking the data in 1970. A record 80% of retailers missed their sales targets — double the norm of 42%. Also, had banks not eased lending standards for credit cards it is likely that consumption in April would have been even worse (see Figure 6). One really has to wonder about the sanity of easing credit conditions for credit cards at a time when the consumer is already badly stretched…..The tightening of other consumer credit lending standards reflects harder to borrow conditions for home equity loans.

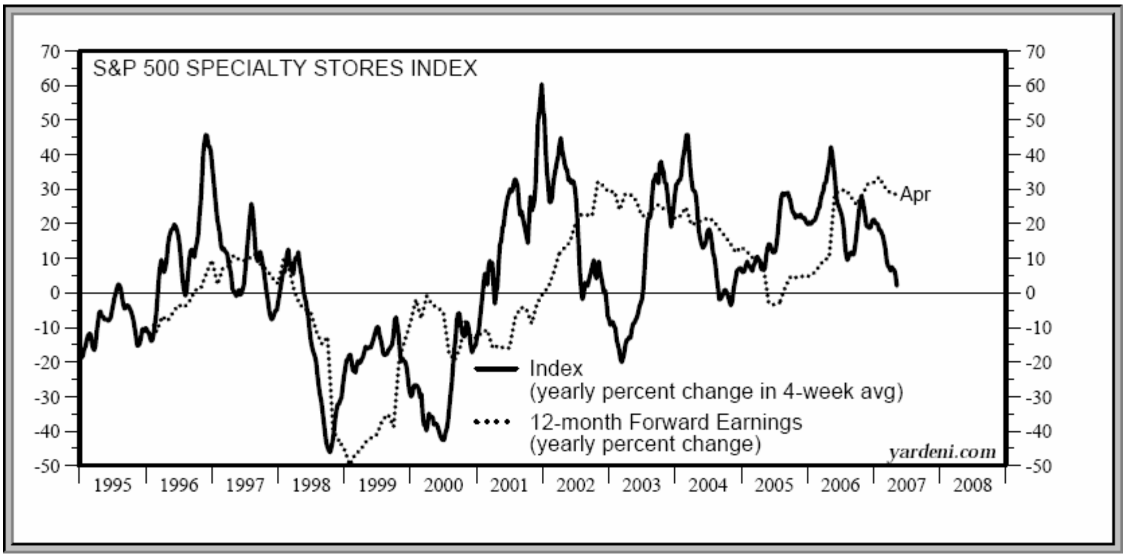
Figure 6: Easier Lending Standards for Credit Cards!



Source: Bridgewater Associates

Since interest rates on credit card balances are the highest, we should conclude that a large number of consumers are in a financially rather desperate situation and that once they realize that home prices will not recover any time soon while food, energy prices and other prices continue to increase, their spending is likely to be curbed rather significantly. In fact, year-to-date, the US Specialty Store Index has been one of the worst performers dropping 3.2% (see Figure 7). Given specialty stores' premium valuation compared to the S&P 500 and specialty stores' elevated earnings, we would advise to avoid the sector as well as other retailers, which derive a high percentage of their sales from consumer discretionary items.

Figure 7: Specialty Stores Index is signaling a Consumer Retrenchment



Source: www.yardeni.com

In fact, according to David Rosenberg, if retail sales data is split into cyclical and defensive sectors, an interesting story emerges: "The defensive or staple segment, basically activity at drug stores and grocery stores, rose 0.6% month-over-month and this took the year-on-year growth rate to 7.0% from 6.4% in March and this is the fastest trend in eight years. The cyclical sectors of retail sales, which comprise autos, electronics, clothing, building materials and furniture, slid 1.0%, which is the largest decline since June 2006 and the year-on-year trend is just 0.6% or basically flat".

The question is obviously why drug store and grocery store sales are rising at an annual rate of 7% while discretionary sales are languishing? I suppose it has to do with prices at grocery and drug stores rising rapidly (certainly more rapidly than the CPI shows) and squeezing discretionary spending. The groups to avoid because they look vulnerable in the current environment of an economic slowdown are consumer electronic retailers (CC, BBY), apparel retailers (LIZ), and sporting good and athletic shoe retailers Dick's Sporting Goods (DKS see Figure 8) and Zumiez (ZUMZ – see Figure 9).

Figure 8: High Valuation and less Buoyant Outlook

Source: www.decisionpoint.com

Dick's Sporting Good (DKS) shares sell for 24-times earnings and Zumiez (ZUMZ – see Figure 9) for more than 50-times earnings. So, under the assumption that the weak housing market will in time lead to a consumption retrenchment and given Dick's and Zumiez' high valuation, a short position could be considered (stop loss at previous highs). Shares of other retailers such as JC Penney (JCP), Nordstrom (JWN), Federated Department Stores (FD), Kohls (KSS), Abercrombie & Fitch (ANF) and Sears (SHLD – but now more of a hedge fund than a retailer) also appear to be weakening.

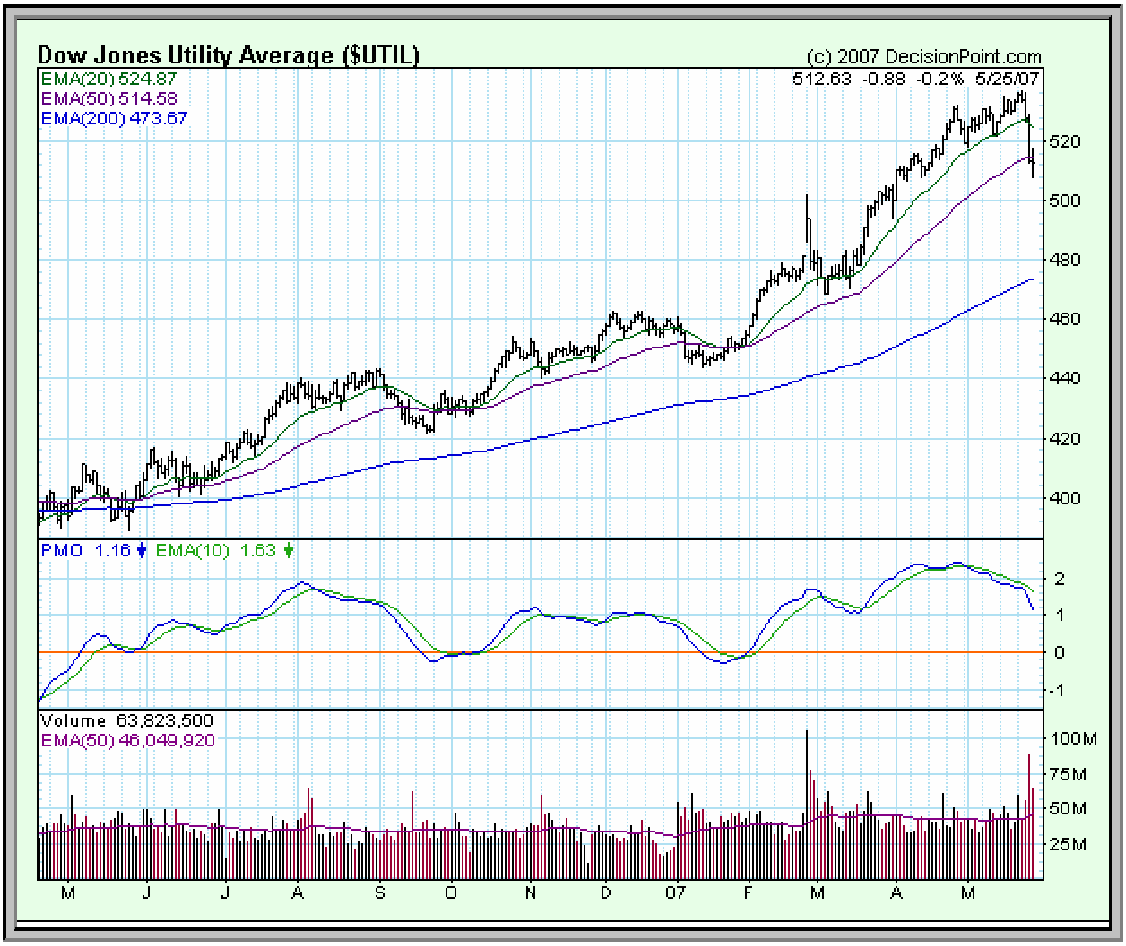
Figure 9: Is Zumiez Worth 50-times Earnings?

www.decisionpoint.com

In addition, other consumer related stocks such as hotels (MAR, HLT), casinos (WYNN), and, as shown in last month's report, Airlines also seem to be rolling over.

I am indebted to Alan Abelson, for having recently addressed in Barron's the conditions in the labor market. As our regular readers of the Gloom Boom & Doom and also of this report know, we have been very skeptical of statistics published by government agencies. In particular, we felt that the inflation figures published by the Bureau of Labor Statistics (BLS) were significantly understating the cost of living increases of households. In fact, market participants may also begin to have similar doubts as reflected by the weakness in bonds and also, more recently, of other interest rate sensitive groups such as Utilities (see Figure 10) and REITs (see Figure 11).

Figure 10: Interest Sensitive Stocks under Pressure!



Source: www.decisionpoint.com

But, back to the conditions in the US labor market. According to Abelson, who quotes the Liscio Report, the very same BLS, which publishes the various labor condition statistics, also publishes the Business Employment Dynamics. "This series reports detailed gross job gains and losses in the private sector based on nearly complete coverage 'of the employment universe provided by the unemployment insurance system.' More painstaking than the familiar monthly surveys of employment, the tally is published with a lag of several quarters; the one released earlier this month, for example, was for the third quarter of 2006….Thus, compared with a gain for the quarter of 442,000 jobs reported in the so-called establishment survey, the Business Employment Dynamics, or BED, reckoning was a scant 19,000 additions. In manufacturing, the 9,000 jobs lost according to the payroll figures balloon into a loss of 95,000 jobs in the BED data; the improbable 20,000 additions in construction (think: housing) turns into a loss of 77,000 by BED's measure; the 507,000 gain in private services shrinks to 108,000. And so it goes. Or, more accurately, so goes the job mirage". Well put, Alan!

Figure 11: Sam Zell Sold Equity Office Property Trust (EOP) to Blackstone for $ 23 Billion right at the February 2007 REIT Peak!

Source: www.decisionpoint.com

The significant difference in both series of the employment data has likely to do with the "Birth/Death" model, which the BLS uses to estimate the gains/losses in jobs from the start-up and the demise of businesses.
I first became familiar with the Birth/Death adjustments by the BLS through the Conference Board's late chief economist Albert Sindlinger (a very nice and humble man), who, in the early 1980s, termed these adjustments "phantom jobs". More recently, Bill King, the author of the outstanding daily "King Report" (billking@ramkingsec.com), has repeatedly commented on this fact distorting phenomenon, which added in the 3rd quarter of 2006 156,000 and 388,000 jobs in the first four months of this year!

The point I want to make is the following. If, as I believe, the US economy has already reached the stagflation phase (weak economy but accelerating inflation), rising interest rates come at a very inopportune time for the economy and also for asset markets. I concede that some bubbles outside the US seem to be even more blown up than the US economic (notably excessive consumption) and financial market bubble (in particular excessive debt) but, as I explained before, when one bubble after the other is gradually deflating, to play the last few asset classes that increase in value (London properties, contemporary art, Chinese equities and other emerging markets and their currencies) becomes increasingly dangerous. As a sign of how far the global asset bubble has already matured is the recent launch of a hedge fund that invests in old violins (according to Florian Leonhard, a London based violin dealer and restorer, it is "financially a dead-secure long term investment" with a target of returning 8% to 12% per year)!

Therefore, as indicated in recent reports, I would lighten up on positions in asset market which are extremely extended and where the risks seem to outweigh the returns. The number of assets, which are still rising, is narrowing and it appears that one inflated asset class after another is gradually no longer appreciating. As an example, the Dow Jones Transportation Average and the Russell 2000 Index are both below their February 2007 (pre-correction) peak. In fact, I believe that some short positions could be initiated. Two recent Bloomberg headlines read: "U.S. Stocks Post 1st Weekly Drop Since March; Utilities Fall". According to Bloomberg: "U.S. stocks fell this week (May 26, 2007), ending the longest stretch of weekly gains since 2004, as rising bond yields and lower-than-expected profit forecasts from technology companies eclipsed some $73 billion in takeover announcements". The other headline read: "Dollar Rises to 6-Week High Versus Euro on Signs of U.S. Growth”. This is the point I have tried to make before. The only way the US dollar can strengthen is to have relatively tight money in the US, which then has negative implications for asset markets. So, whereas I really cannot be a US dollar bull for the long term, near-term, additional dollar strength may pressure the stock market further. Therefore, investors could consider shorting some index futures or to purchase some ETFs, which move inversely to the stock indices ((however, not recommended for the faint hearted - see Figure 12)

Figure 12: Some Hedging (or Shorting) is now Recommended!

Source: www.decisionpoint.com

There are several ETFs, which move inverse (opposite direction) to the various indices. The Ultra Short S&P500 ProShares (SDS), correspond to

200% of the inverse performance of the S&P500 (see Figure 12). The Short Dow 30 ProShares (DOG) the Short MidCap 400 ProShares (MYY), the Short QQQ ProShares (PSQ), and the Short S&P500 ProShares (SH) all move in the opposite direction of the respective indices. For more conservative investors, I continue to recommend the purchase of US treasury bills for now. Precious metals are correcting and a favorable entry point will present itself sometime in the next three months. Cotton is one of the most depressed commodities and contrarian investors should gradually enter the market.

I should like to emphasize that each investor must decide for himself how much risk he can take given his particular financial condition and under consideration of his entire exposure to the various asset markets. Obviously, I cannot be each reader's personal financial planner.