Relief Rally?

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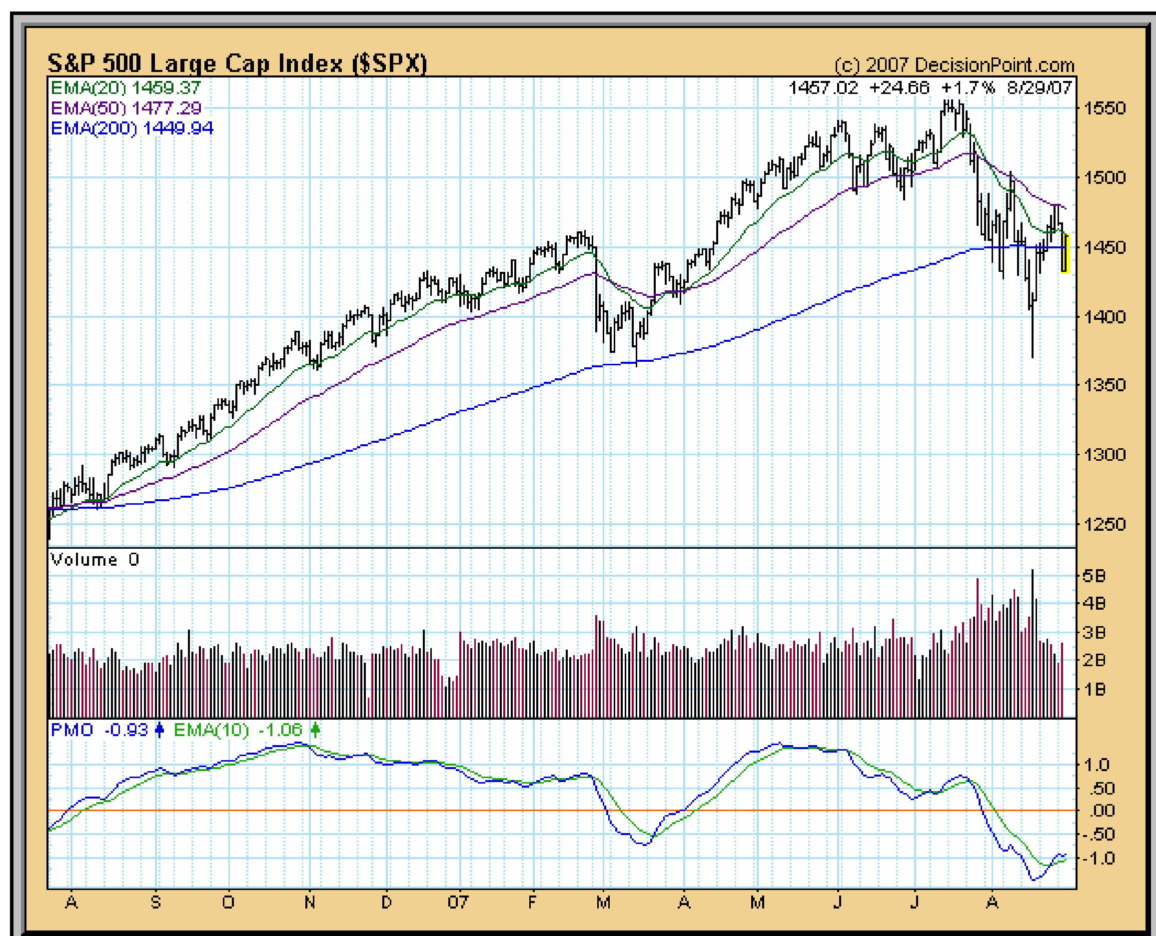
From an intraday low at 1370 on August 16, the S&P 500 rallied by more than 100 points to a recent high at 1479 (see Figure 1). Coming from a deeply over-sold condition the rally was not surprising but disappointing for two reasons. Volume diminished, and on each day of this rally the number of NYSE stocks making 52-weeks new lows exceeded the number of stocks reaching 52-weeks new highs.

Figure 1: An Unconvincing Stock Market Bounce!



Source: www.decisionpoint.com

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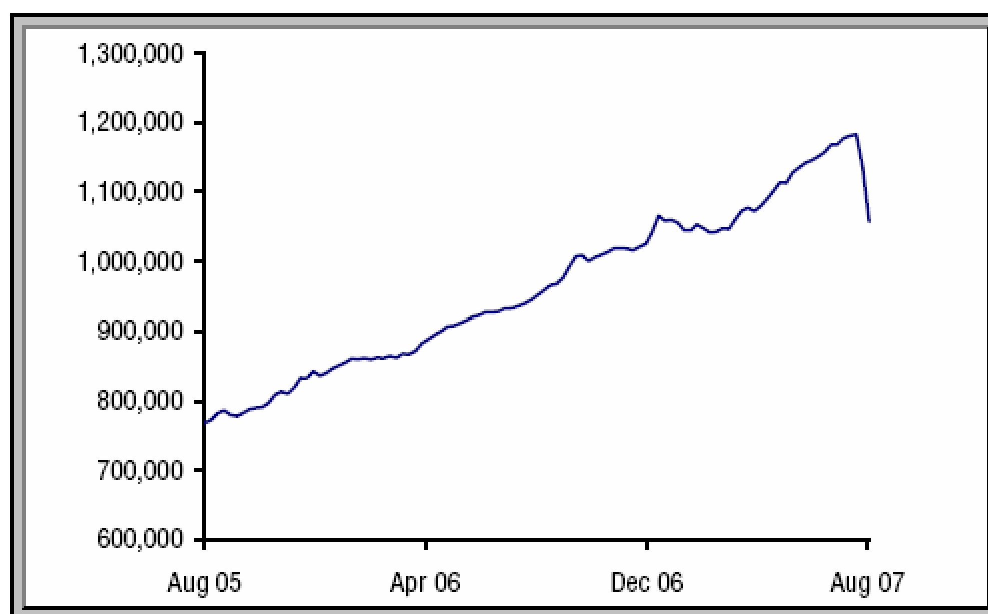
And while the optimists remain convinced that the recent correction was just another correction in a rising trend which will give way to new highs before the end of the year, my friend Jim Walker at CLSA has a different take. According to Jim,

"in order to believe that (this is all a bad dream and easy money will return soon) you have to believe that the US sub-prime market will settle down and the CDO issuance that is associated with it will resume as if nothing has happened after the dust has settled. You also have to believe that structured finance products are readily modeled and are not subject to market gyrations or risk changes. You also have to believe that all the people that have already been burned (hedge fund clients, pension funds, Asian and European banks, ordinary investors and so on) will be willing to take on the next set of issues at the same price as they did before. You have to believe all this because systems built on easy money demand more and more of it every year. If you are willing to believe all that then 'buy the dips' because, in my view, the person that is selling to you deserves the money more than you do".

In particular, Jim points out to the decline in Asset-backed Commercial Paper outstanding to emphasize his point about slower credit growth (see Figure 2)

Figure 2: US: Asset-backed Commercial Paper Outstanding (S.A.)



Source: US Federal Reserve, Jim Walker, CLSA

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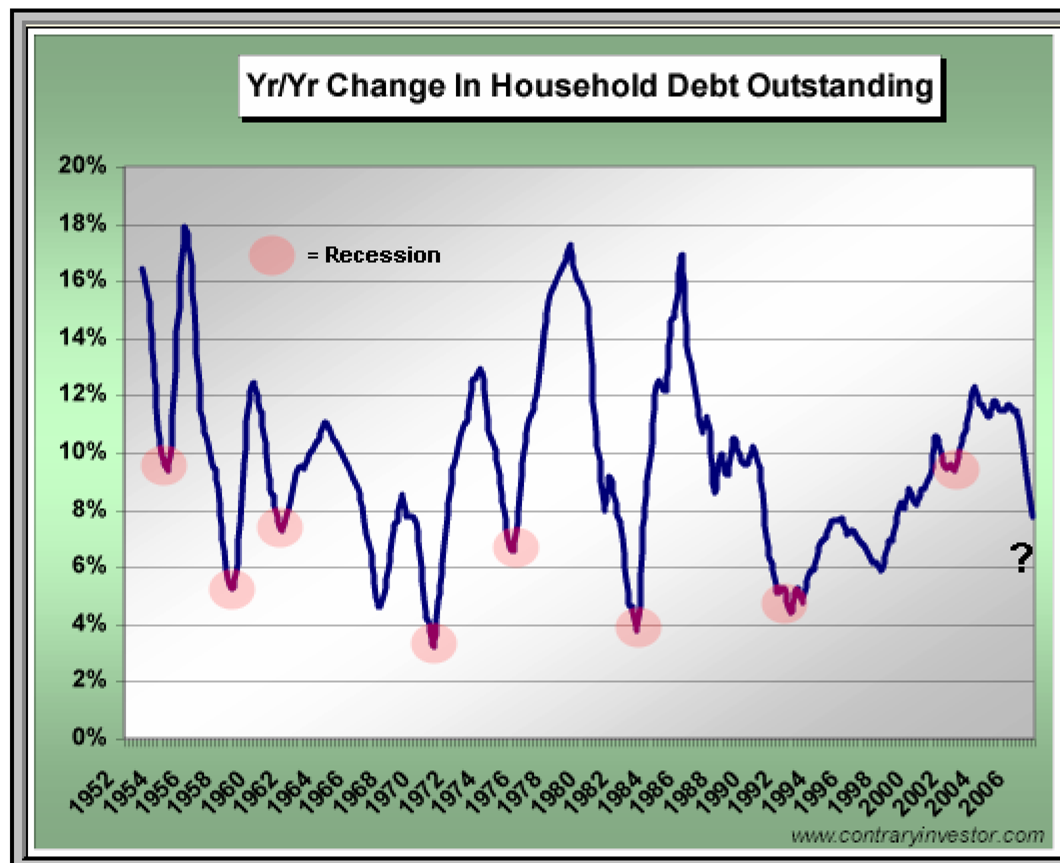
I think Jim Walker makes a very good point about a slow-down in credit growth, which has already been evident for some time in the case of household debt growth (see Figure 3).

Figure 3: A Slowdown in Household Debt Growth!



Source: www.contraryinvestor.com

So, if we combine the decelerating rate of growth of credit and the fact that significant overhead supply exists for the S&P 500 between 1500 and 1540, new highs will be difficult to achieve (see Figure 1).

Still, the following should also be considered. Since October 2002, all asset prices have "inflated" in concert. At the end of a major bubble it is common for the leadership to narrow with just one sector of the market still soaring while the rest of the market falls by the wayside. It is, therefore, conceivable that US stocks could still make a new high while most other assets would no longer appreciate (see Figure 4).

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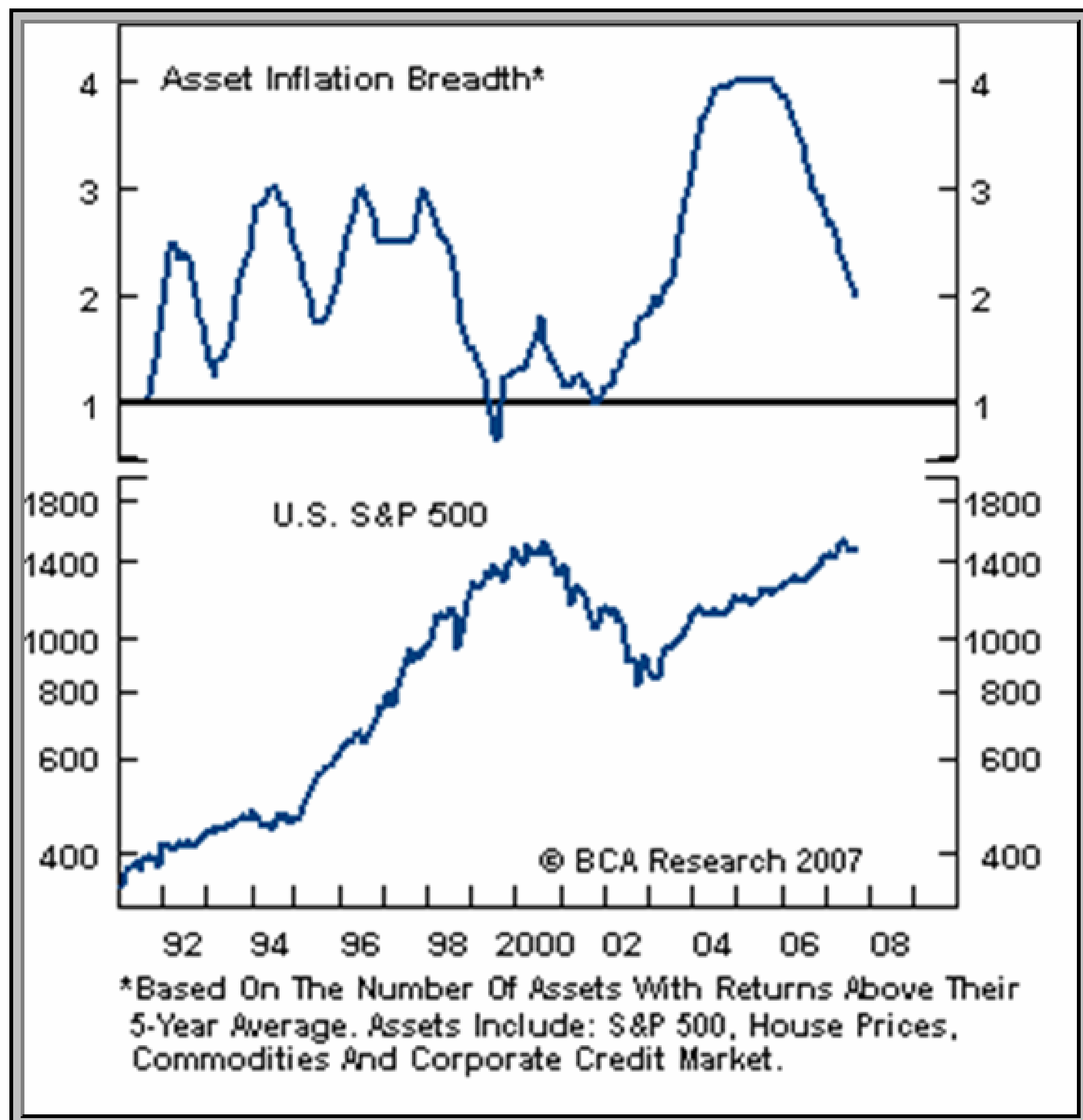
Figure 4: Diminishing Breath of Asset Inflation



Source: The Bank Credit Analyst

I am mentioning this possibility because Jim Grant recently wrote in the New York Times that, "**a third remarkable aspect of the summer's troubles is the speed with which the world's central banks have felt it necessary to intervene. Bear in mind that when the Federal Reserve cut its discount rate on Aug. 17…the Dow Jones industrial average had fallen just 8.25 percent from its record high……Why does the Fed feel the need to intervene at the drop of a market?** The reasons have to do with an idea set firmly in place in the 1930s and expanded at every crisis up to the present. This is the notion that, **while the risks**

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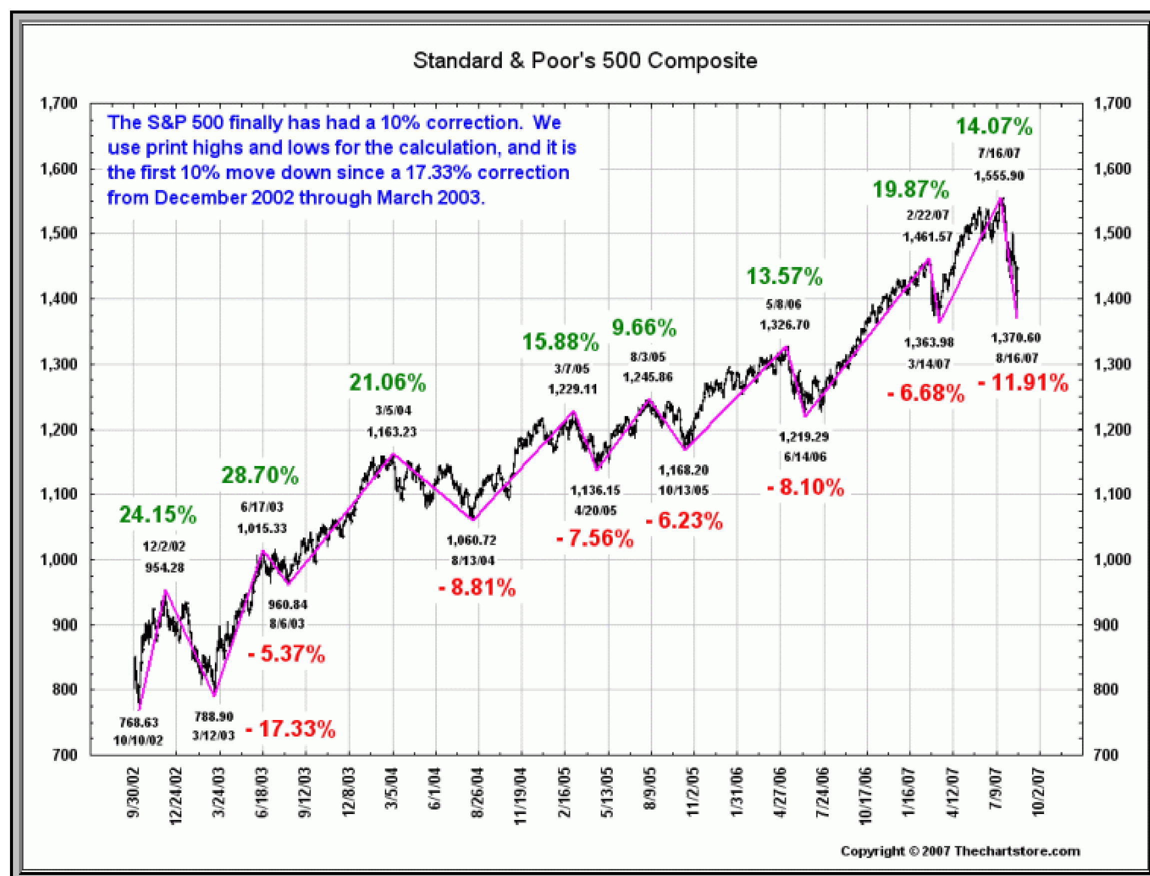
inherent in the business of lending and borrowing should be finally borne by the public, the profits of that line of work should mainly accrue to the lenders and borrowers. It has not been lost on our Wall Street titans that the government is the reliable first responder to scenes of financial distress, or that there will always be enough paper dollars to go around to assist the very largest financial institutions… Ben S. Bernanke, Mr. Greenspan's successor at the Fed (and his loyal supporter during the antideflation hysteria), is said to be resisting the demand for broadly lower interest rates. Maybe he is seeing the light **that capitalism without financial failure is not capitalism at all, but a kind of socialism for the rich".**

Still, I doubt that the Fed will resist supporting the stocks market at the expense of a weaker US dollar and higher inflation. This would mean that a new high for the stock market in dollar terms is possible (see Figure 5).

Figure 5: Another New High?



Source: Ron Griess, www.Thechartstore.com

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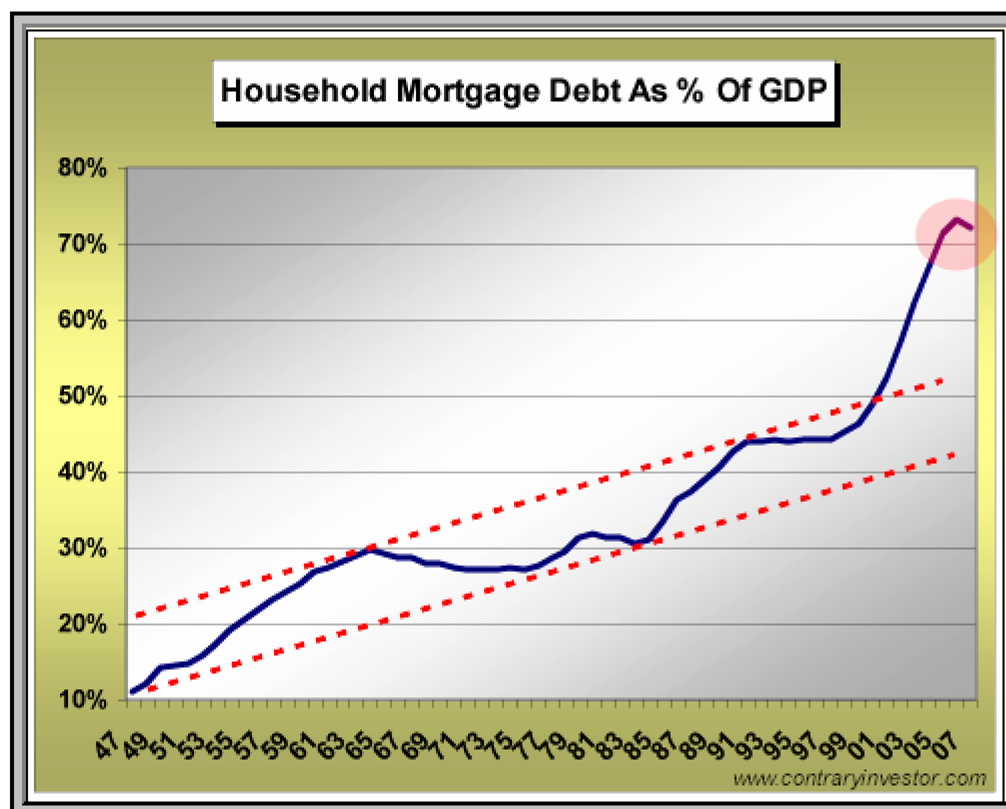
In this context we should not forget that Mr. Bernanke's main thesis – about which he has both repeatedly written and spoken – is that the Great Depression could have been avoided if the Fed had flooded the system with liquidity right away. He is also the man who suggested that if deflation became a real threat the Fed could always drop money from a helicopter onto the US. According to Stephen Roach, "the lack of monetary discipline has become a hallmark of unfettered globalization. Central banks have failed to provide a stable underpinning to world financial markets and to an increasingly asset-dependent global economy." Therefore, I remain skeptical that the Fed will refrain from engineering a major monetary bail-out of the system. The problem with such policy is that the stress in the system is shifted from the lower quality credit market and the stock market to the US dollar, which will continue to be debased (certainly against gold). But there is another point to consider. Look at Figure 6!

Figure 6: Record Mortgage Debt!



Source: www.contraryinvestor.com

As can be seen from Figure 6, mortgage debt as a percent of GDP is now at 70% compared to 40% at the time of the 1998 LTCM crisis. So, my

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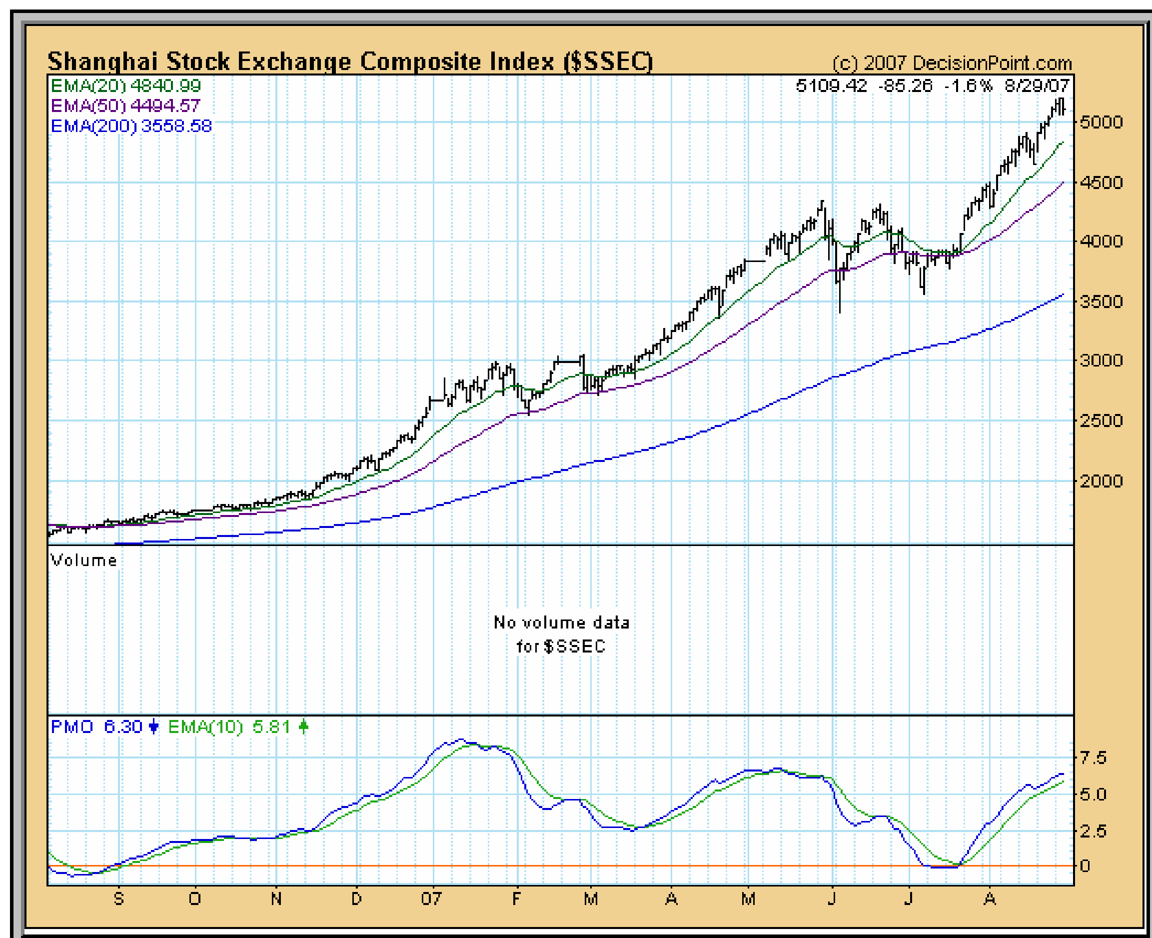
view is that unless the Fed is prepared to accept a vicious recession it has **no other option but to bail out the system no matter how unpleasant the consequences will be in the future.** The problem is really that in recent years the Fed has never controlled credit growth and that the monster needs now to be fed with even more money and credit growth. Admittedly, "easy money" may not do the trick for housing, which is likely to continue to deflate in real terms (inflation adjusted), but it is possible that amidst a deteriorating global asset bubble advance/decline line (fewer and fewer assets making new highs) the one or the other asset market will still make a new high. After all, the Shanghai stock market has so far not been affected by the mortgage related credit crisis (see Figure 7).

Figure 7: Another Bubble in the Making!



Source: www.decisionpoint.com

As an aside, the Shanghai Stock Exchange Index trades now 55% above its 200-day moving average (it is therefore extremely overbought) and it

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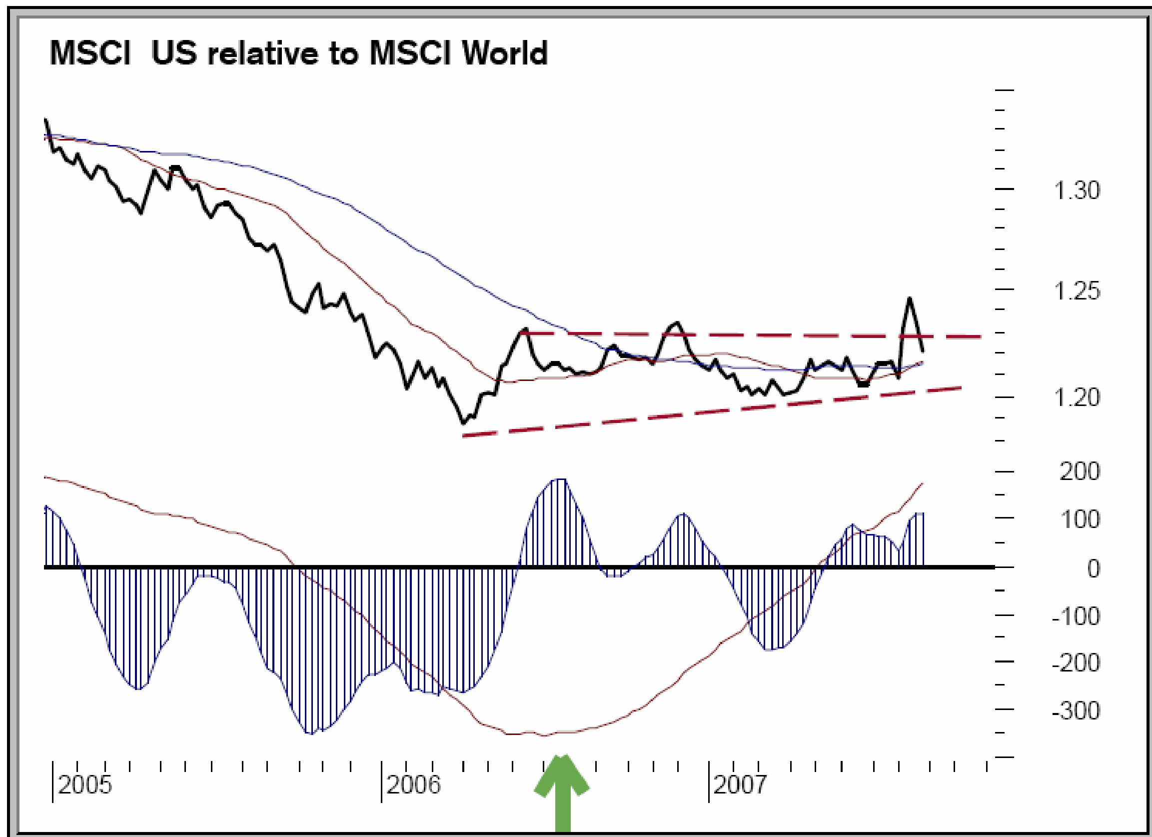
is up from its June 2005 low by over 4-times. This is not to say that Chinese and also Hong Kong shares cannot continue their up-trend but obviously they are becoming increasingly vulnerable to a very steep downturn, which I would expect to begin sometime between now and the summer 2008 Olympics. My point is simply this: When emerging markets will break down sometime within the next 9 months the US stock market is likely to out-perform foreign markets (see Figure 8). Since I assume that this insight will not have escaped the attention of large global money managers, they are likely to increase their exposure to US equities in future. This, particularly, if the US dollar weakens further. Therefore, despite being negative about the US economy and its financial market, I am reluctant to be heavily short US equities.

Figure 8: Weak Dollar – Strong Stock Market



Source: www.credit-suisse.com/techresearch

I concede that my views may be somewhat confusing. Earlier, I mentioned that new US stock market highs were unlikely for the rest of the year and just above I seem to be "relatively" positive about US

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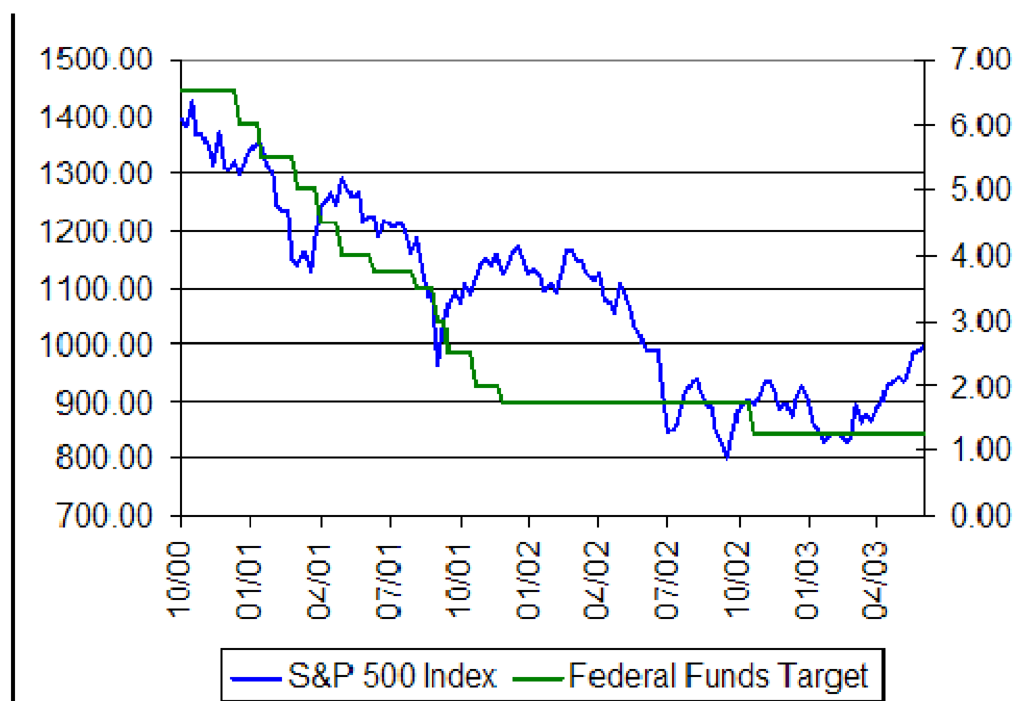
equities. But consider the following. The confusion arises because of the market manipulation by the US Federal Reserve. Were the Fed not directly intervening into the free capital market this confusion would not arise. In fact, the Fed is so driven by asset price changes that one could envision the following scenario. If by the next Fed board meeting on September 18, the S&P 500 is above 1520, Fed fund rate cuts would unlikely be announced. Conversely, if by then the S&P 500 is around 1400 or below, Fed fund cuts become highly likely. The question is of course whether Fed fund cuts will re-ignite the bull market. In two previous instances, stocks rallied repeatedly on Fed fund cuts, but the over-all trend was down (see Figure 9 and Figure 10).

Figure 9: S&P 500 and Fed Fund Rate, 2000 - 2003



Source: Michael Belkin

In fact, I remember very well the first rate cut on January 3, 2001, because I spent that evening at the Palace hotel in St. Moritz where all the big high tech bulls were having dinner. One of them then came over and – knowing that I was the great high tech bear - triumphantly announced that the Fed had cut rates and that the stock market was up strongly. Unfortunately for him, the relief rally did not last for long (see Figure 9). Similarly, in the early 1980s, stocks continued to decline despite a series of rate cuts (see Figure 10).

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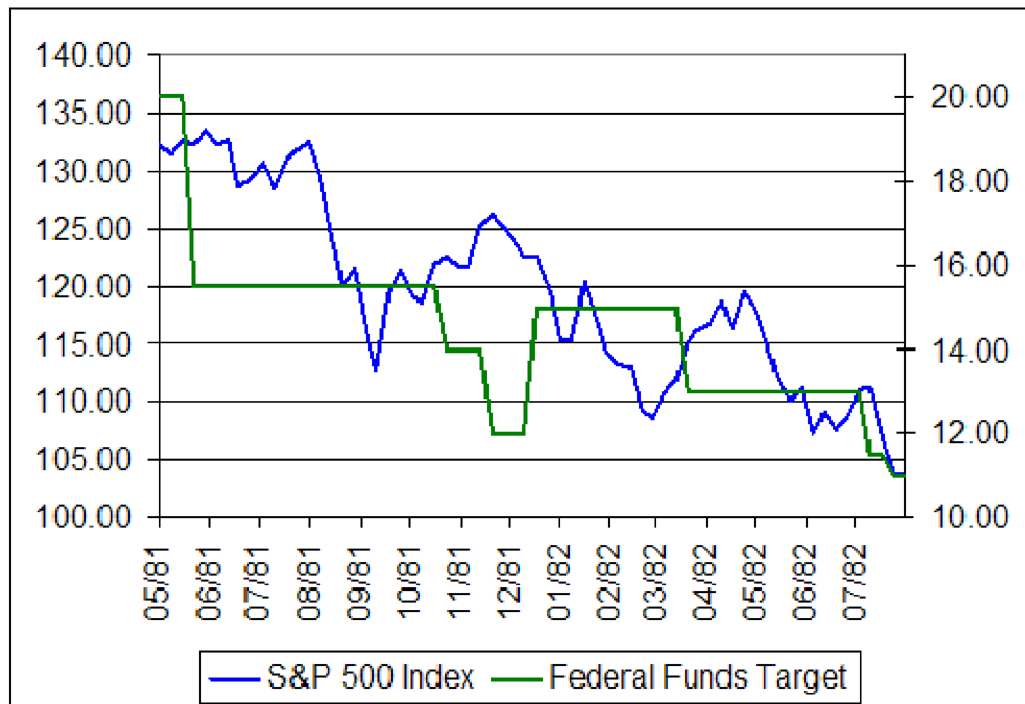
Figure 10: S&P 500 and Fed Fund Rate, 1981 - 1982



Source: Michael Belkin

So, if I look at the investment environment I cannot get excited about participating in the ongoing battle between **market fundamentals**, which are, in my opinion, a disaster, and the **manipulation by the Fed** (and possibly at some point also by the government), which could boost US asset prices or at least prevent them from declining as much as the bears (including myself) would like them to do. In military battles even the victors have a very high casualty rate. Therefore, I suppose that in the ongoing financial battle between the optimists, who expect a new high shortly, and the pessimists, who expect a new low before the end of October, the best course of action may be to only take small positions and to be patiently awaiting better entry points both on the long and the short side. However, if some of my readers are very optimistic, I recommend them to buy gold and gold shares rather than the S&P 500 and other major US indices. At the same time, I would continue to avoid the financial sector, which is in a credit contraction the most vulnerable industry. It is only a massive injection of liquidity that could reignite a further up-ward move in the global asset bubble, which would be nothing else than another major debasement of paper currencies.

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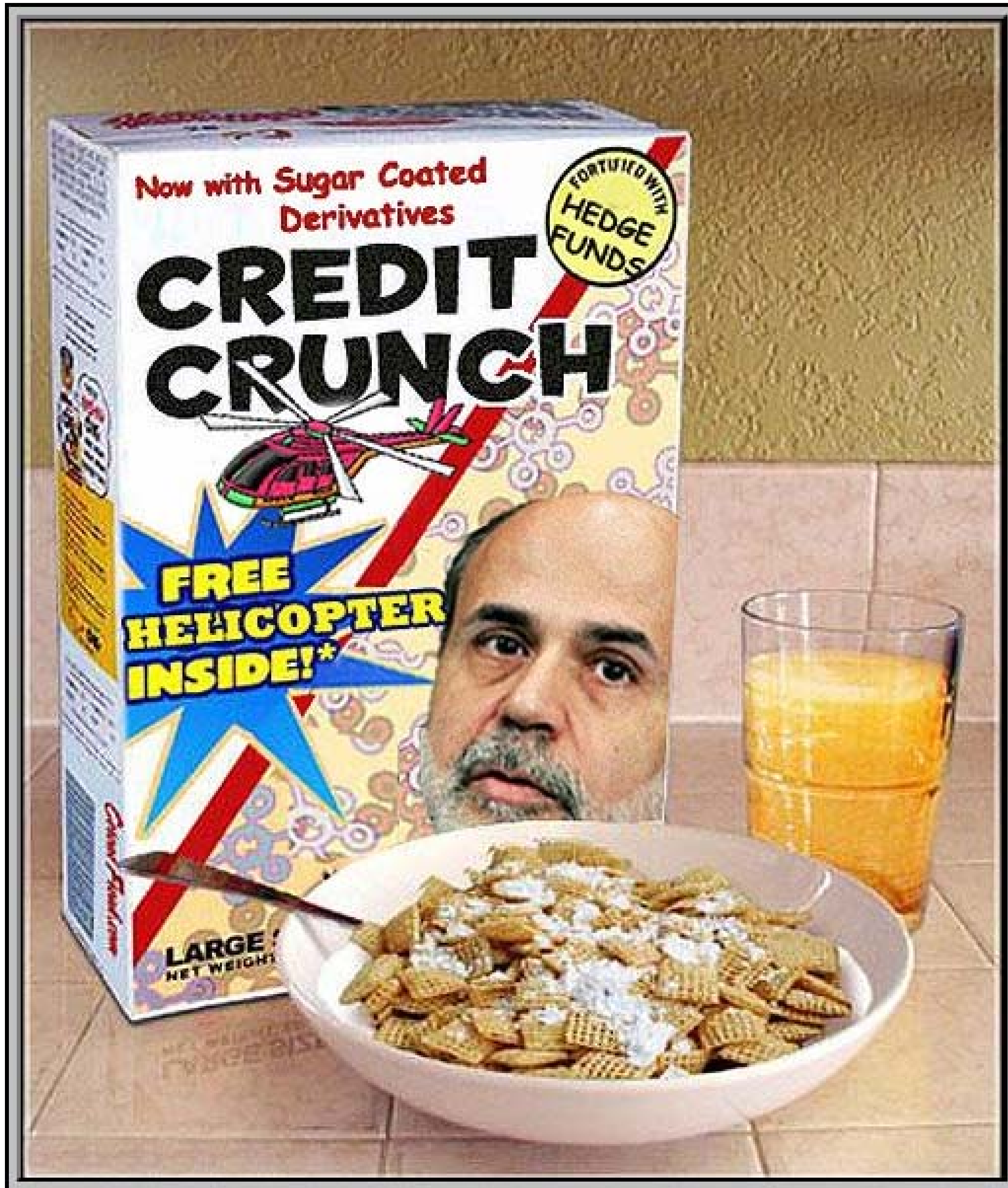

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