A Buying Opportunity?

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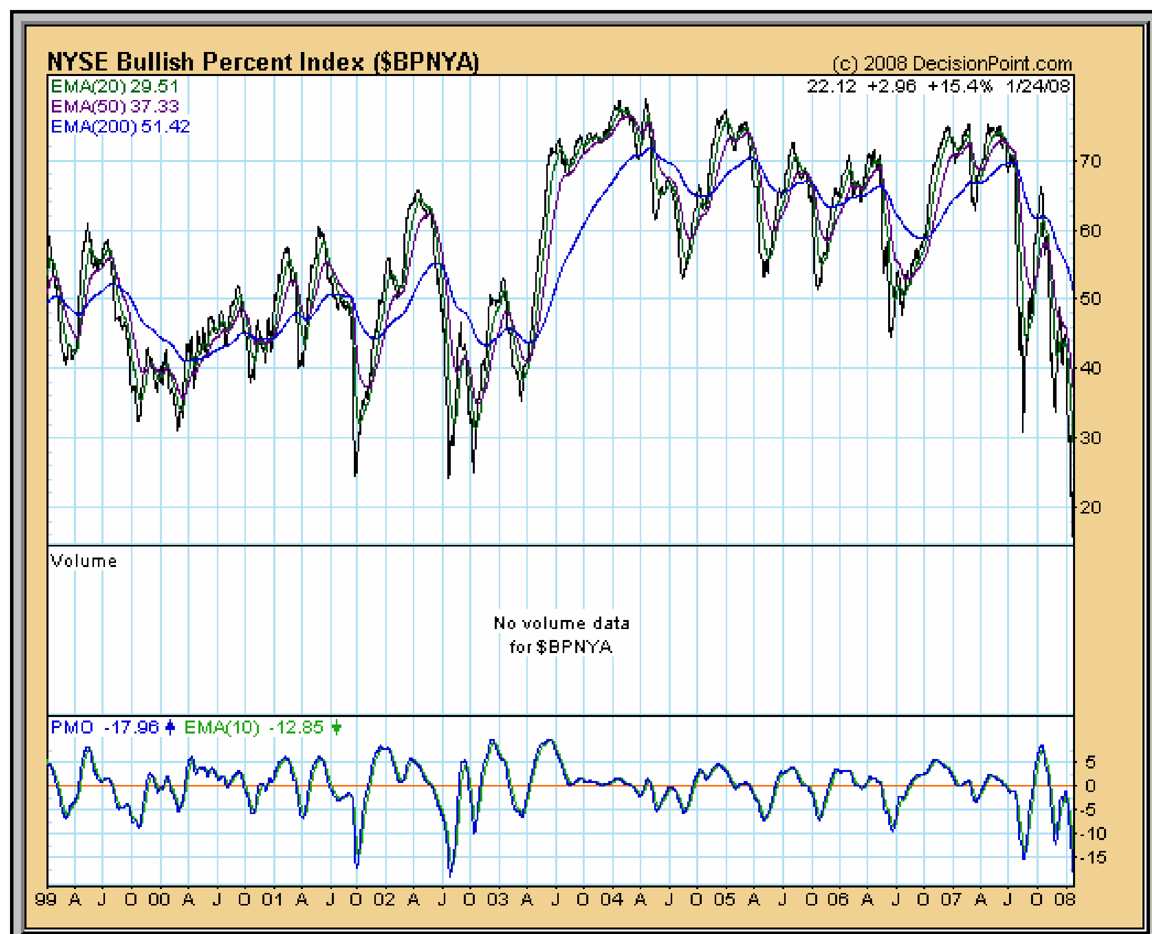
Based on sentiment readings, the number of 12-month new lows and numerous technical indicators such as the NYSE Bullish Percent Index, the US stock market became at the end of January very oversold from an intermediate point of view (see Figure 1).

Figure 1: Extreme Oversold Conditions suggest Rebound



Source: www.Decisionpoint.com

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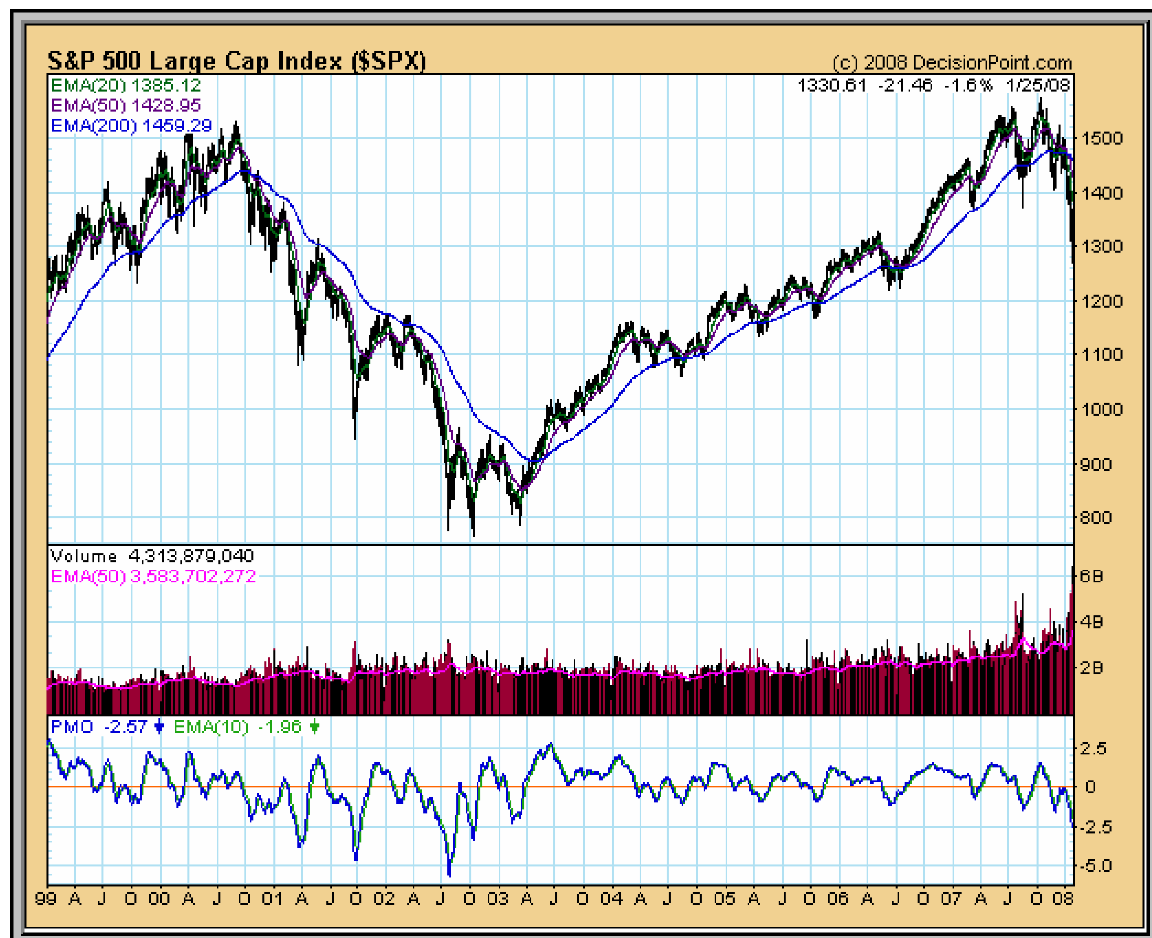
Also to consider is that we had in a very brief period (three months) a very sharp decline globally in all major indices. The S&P 500 dropped from an intraday high of 1576 on October 11, 2007 to an intraday low of 1270 on January 23, 2008 (see Figure 2). In other words, in a little more than 3 months the S&P 500 crashed by almost 20%!

Figure 2: S&P 500, 1999 – 2008: Correction or Bear Market?



Source: www.Decisionpoint.com

In addition, as can be seen from Figure 2, strong support for the S&P 500 exists at the July 2006 low around 1240. I may add that in Euro terms the S&P 500 has now declined to the range it traded at in 2003 and 2004!

Overseas the carnage was even more severe. Hong Kong's Hang Seng Index collapsed by 32% from a high of almost 32,000 on October 30, 2007 to an intraday low of less than 22,000 on January 22, 2008 before rebounding (see Figure 3).

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Figure 3: Hang Seng Index: An almost 32% Collapse!

Source: www.Decisionpoint.com

The obvious question investors are facing now is whether the current stock market rout around the world is similar to the 1998, 1990 or 1987 corrections, which all provided great buying opportunities or whether we just completed the first leg of a more severe and longer lasting bear market. I can sympathize somewhat with the goldilocks' crowd view that the current decline does provide a buying opportunity because the magnitude of the decline is similar to the 22% drop in 1998 (from the October 9, 1998 low the stock market rallied by 33% to the end of the year) and the 19.3% decline in 1990, which was followed by the great bull market of the 1990s. In 1987, the S&P 500 collapsed by 33% between August and October and provided at its panic low a tremendous buying opportunity, as it resumed its up-trend, which lasted until 2000. The goldilocks view is best summarized by Thomas Peterson of Bull Eye research, who pointed out in mid January that, "this decline has been a market event, not an economic event. That may change this week. But we

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note the Fed has amble room to cute rates - is it too late? We don't know. What we know is the money supply has been rising significantly in the past 12 months as central banks have tried to inject funds to offset some of the financial institutions' losses. That money hasn't disappeared. Companies still have lots of cash. As of last week, there were also enormous piles of cash sitting in many U.S. funds, in addition to that recorded in money market funds. U.S. stocks are under-owned according to several surveys. These are reasonable buffers to limit the downside. In the past, when we have had this combination of factors, the market has gone down temporarily. As in 1990 and 1987, but it has always become a great buying opportunity."

Personally, I am not so sure that we are dealing here merely with a "market event" and not with "an economic event" (see also below). I am leaning more toward the view of George Soros, who thinks that, "the current crisis is not only the bust that follows the housing boom, it's basically the end of a 60-year period of continuing credit expansion based on the dollar as the reserve currency".

Moreover, I doubt that there are "enormous piles of cash sitting in many U.S. funds" because equity mutual fund cash positions were at the end of last year at a record low. Also, at the end of last year, Barron's surveyed 12 Wall Street strategists. With the exception of two strategists whose 2008 year-end target for the S&P 500 was 1525, all the others had year-end targets of between 1600 and 1750! In other words, just before the current rout in the stock market, Wall Street was very positive about stocks. Under these conditions it would be unusual to sit on "enormous piles of cash". In fact, concerning the current negative sentiment toward the market I think that it is negative not because fund managers have become bearish about the market's outlook, but because they were fully invested during the recent collapse and, therefore, lost tons of money. I may add that a recent Bloomberg poll, carried out when the S&P 500 had already declined to 1390, revealed that among the 15 top strategists surveyed the average US equity allocation was 61.8%. Moreover, they were all positive with their year-end targets for the S&P ranging from 1500 to 1700 (it averaged 1,632 - a 17% gain from 1390 when the survey was carried out).

Another view is that we are dealing here with a more serious bear market such as we had in 1969/70 (down 36%), 1973/74 (down 48%), 1981/82 (down 27%) or between 2000 and 2002 (down 48% - see Figure 4).

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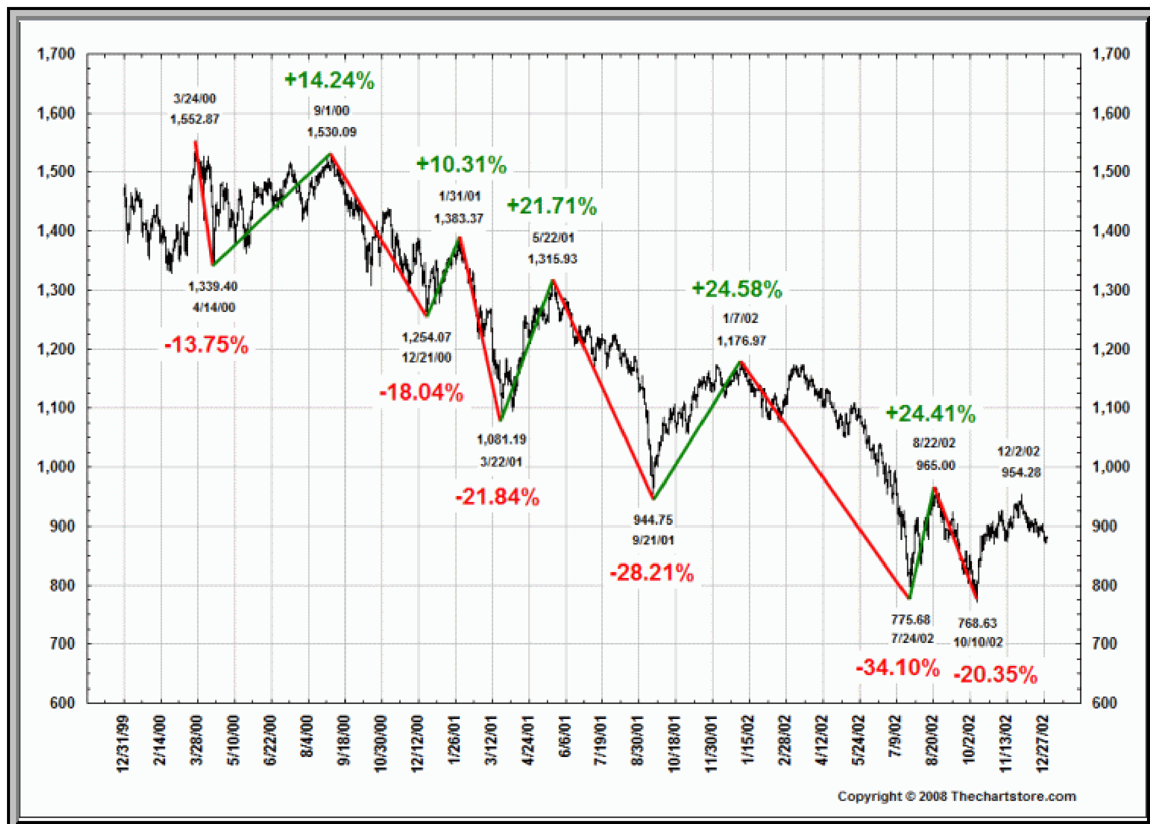
Figure 4: S&P 500, 1999 – 2002



Source: Ron Griess, www.Thechartstore.com

Important to understand in the context of the possibility that we are at the beginning of a lengthy bear market is that, although a bear market leads to lower prices, it is interrupted by very strong intermediate rallies. As can be seen from Figure 4, the 2000 – 2002 bear market was interrupted by two rallies of more than 10% and three rallies of more than 20%!

Similarly, the 1973/74 bear market was characterized by repeated strong rallying phases as fund managers remained largely positive about the outlook for corporate profits and the economy (see Figure 5).

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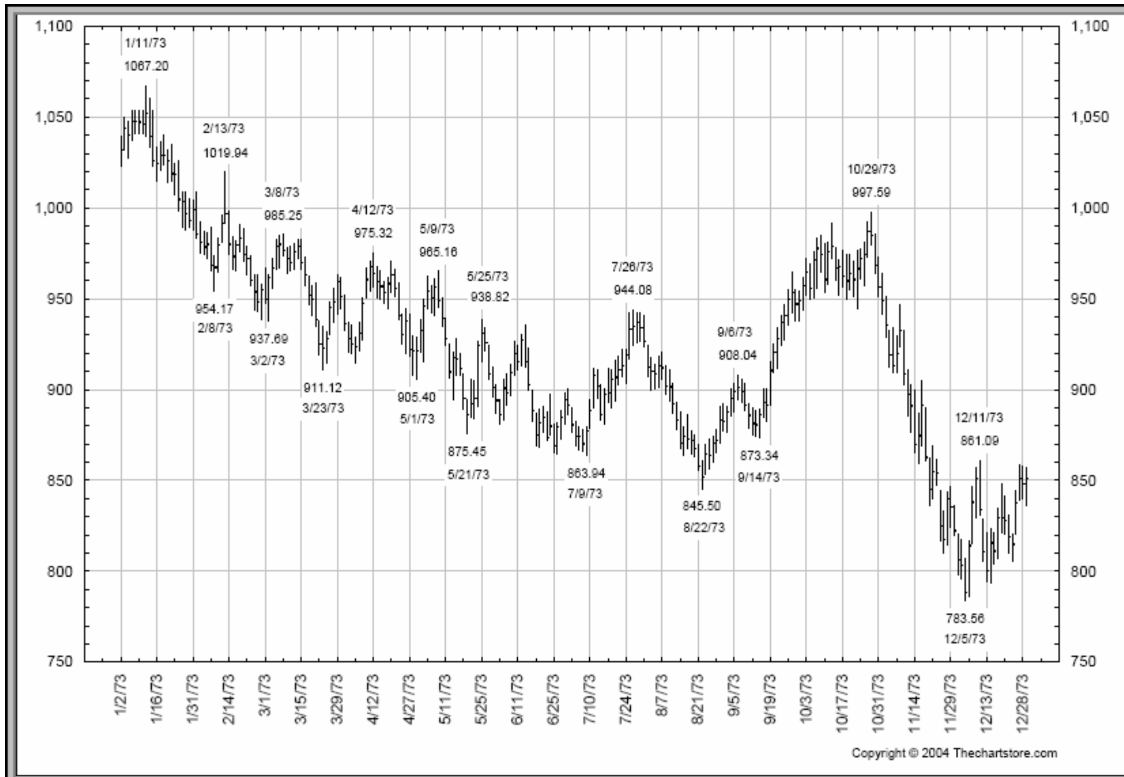
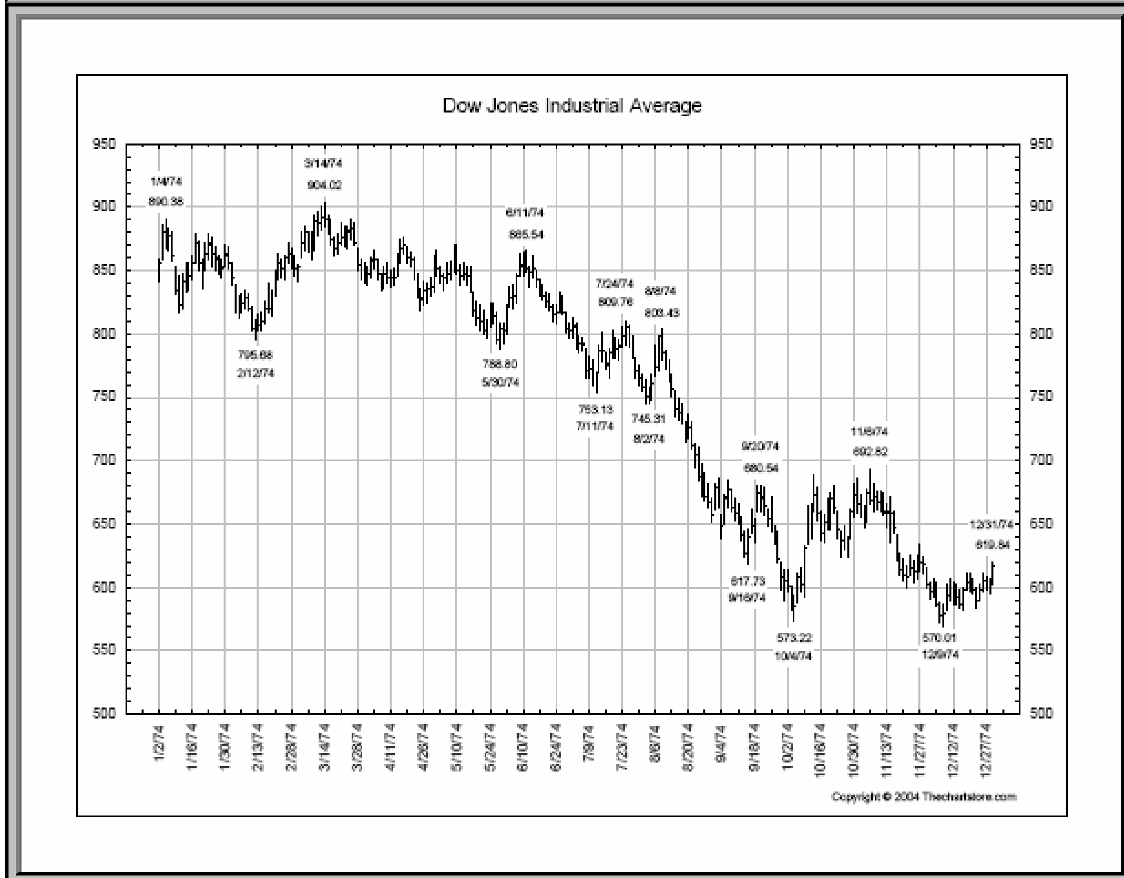
Figure 5: The 1973 – 1974 Bear Market





Source: Ron Griess, www.Thechartstore.com

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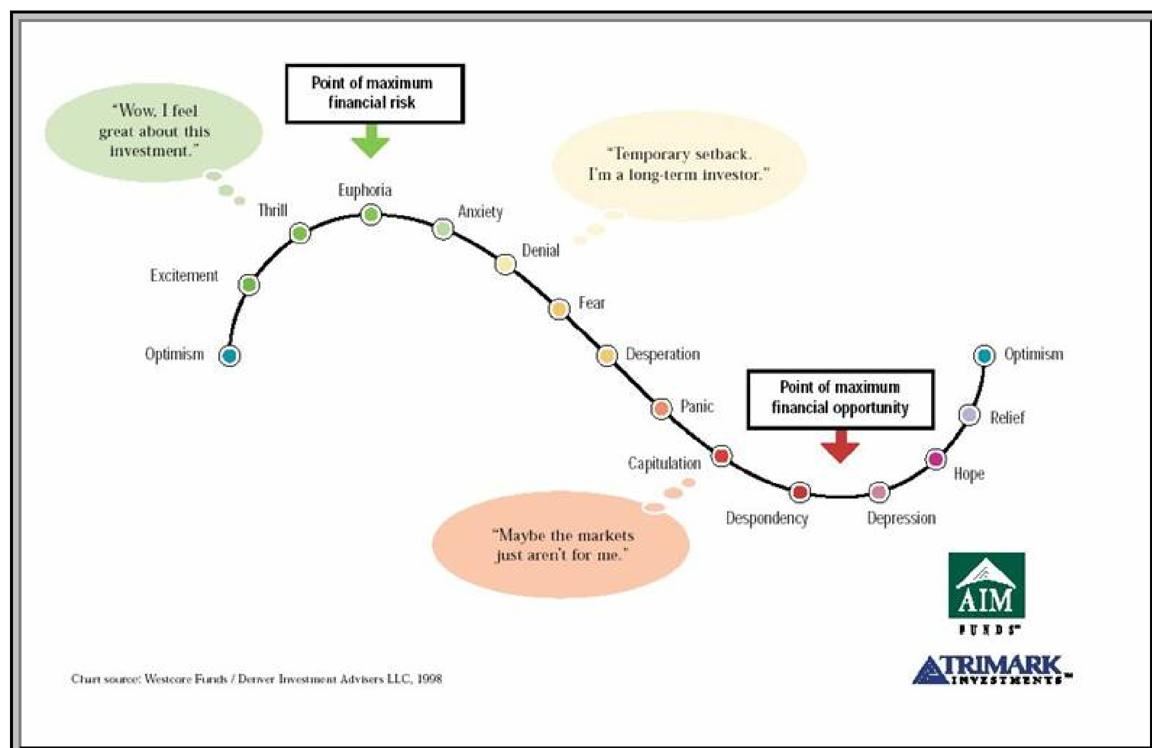
Since I worked at the time of the 1973/74 bear market for the esteemed firm of White Weld & Co, Inc as a stock broker I remember well how throughout the bear market analysts and strategists remained bullish. As "quality" growth stocks such as Memorex, Burroughs, Polaroid, Levitz Furniture etc. declined by 80% to 90% in value, buy recommendations were continuously issued (not much seems to have changed since then). It is only in the final months of 1974 that complete capitulation was reached (see Figure 6).

Figure 6: Psychology during Stock Market Cycles



Source: Denver Investment Advisors

I may add that in the final months of 1974 the mood was desperate. Brokerage firms were going out of business and numerous former stock brokers were employed as taxi drivers. Institutional funds had lost 50% of their money from the peak in 1973 to the trough in late 1974 and most importantly cash positions among equity mutual funds had soared (see Figure 7).

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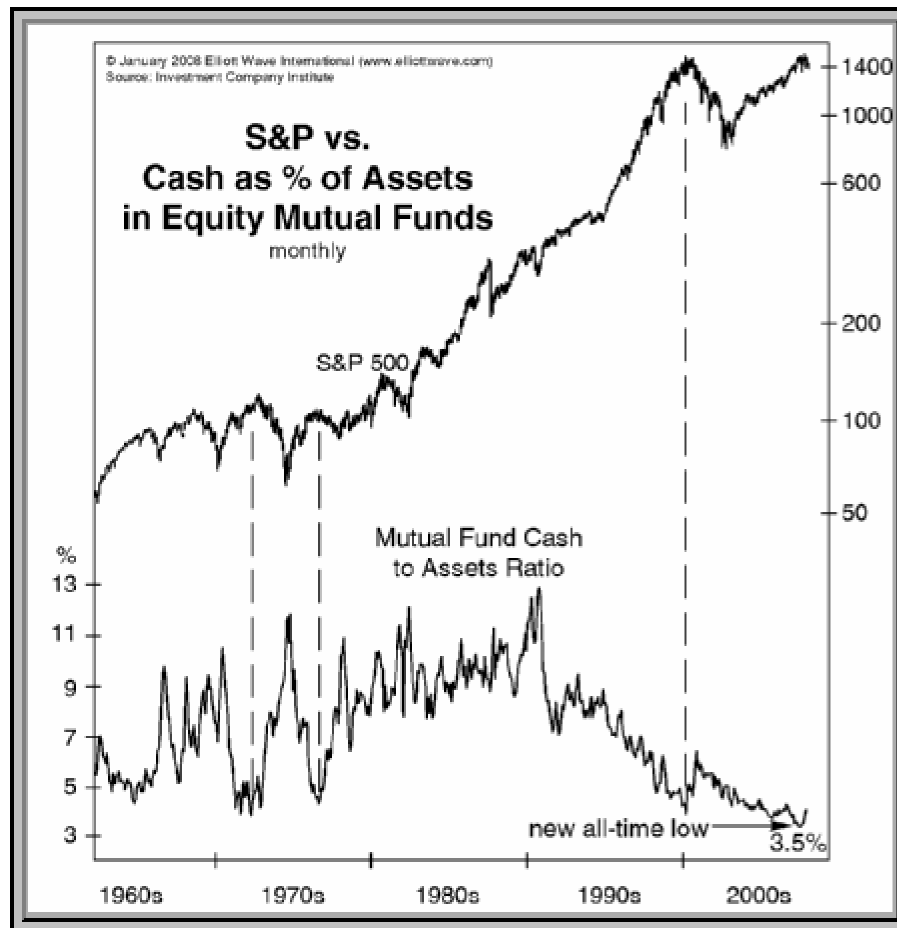
Figure 7: Cash Positions in Equity Mutual Funds, 1960 - 2007



Source: Robert Prechter, www.elliottwave.com

Cash positions among equity mutual funds also increased sharply in 1990. Therefore, I believe that, before a major buying opportunity will present itself in the current market decline, cash positions will have to increase significantly. Once again, there is a difference between being "bearish" because of being caught on the wrong foot (fully invested and therefore incurring losses) and bearishness which leads to widespread selling, desperation and getting out of equities at all cost. This does not seem to have happened yet.

Also, I disagree with the notion that "this decline has been a market event, not an economic event" for a number of fundamental reasons, which lead me to believe that we may be facing something more serious. If we look at Household Real Estate Assets Change in Value Year-on-Year as a Percent of Disposable Income and Household Equity Assets

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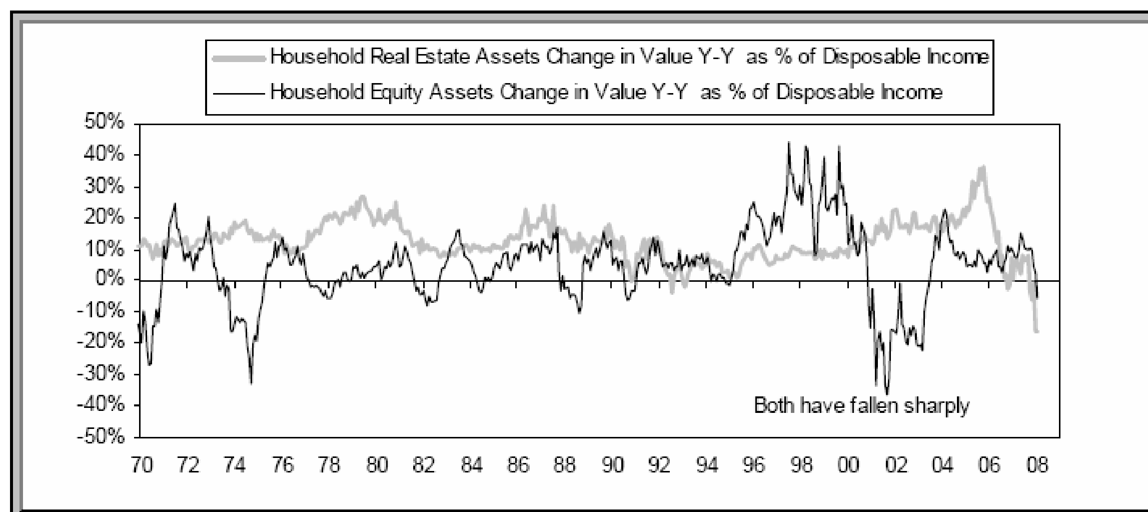
Change Year-on-Year as percent of Disposable Income, the following is obvious. In 1987, 1990, and 1998 both Household Real Estate Assets and Household Equity Assets never declined simultaneously (see Figure 8). Even in the economic slump of 1974 and 1981/82 Household Real Estate Assets did not collapse (in the shallow 2001 recession they even increased - see Figure 8). As Bridgewater Associates notes, "past equity market declines have been cushioned by the improvement in other household assets, most notably real estate assets, stimulated by falling interest rates. Today, the story is different. Both housing declines and stock price declines are combining to weigh on household wealth. This type of correlated asset behavior has not occurred since the 90 slowdown **and never in the same magnitude**" (emphasis added).

Figure 8: Simultaneous Decline in Household Real Estate and Equity Assets!



Source: Bridgewater Associates

Since the decline in household wealth is unprecedented, is safe to assume that consumption will be affected in the period directly ahead (see Figure 9).

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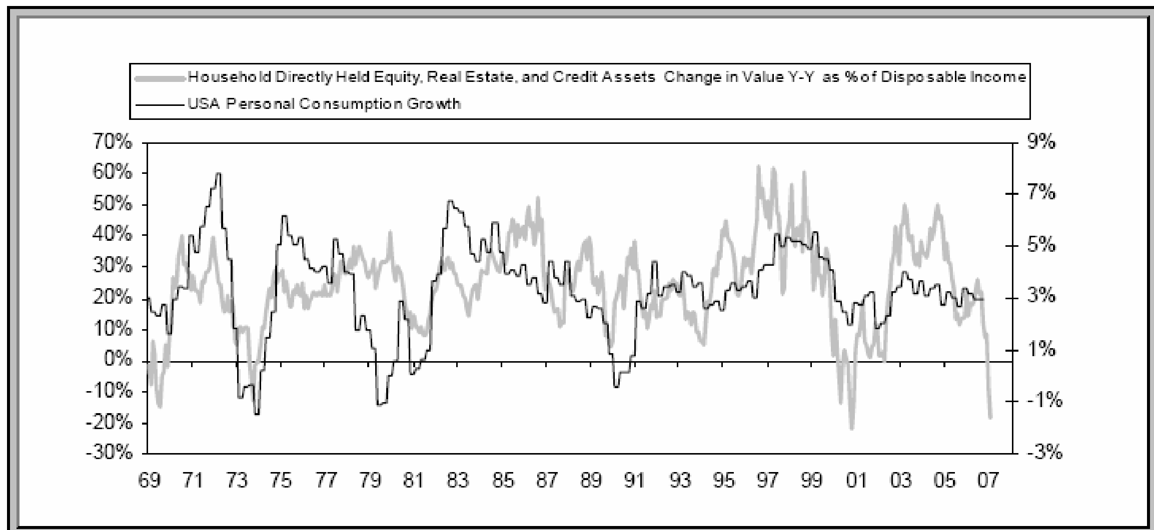
Figure 9: Household Directly Held Equity, Real Estate and Credit Assets in Value Year-on-Year as Percent of Disposable Income and Personal Consumption Growth, 1969 – 2007



Source: Bridgewater Associates

From Figure 9 we can see that, in the past, declining household wealth led to declining consumption growth (sometimes it was declining consumption growth which led to a decline in household wealth) with one exception – the 2001 shallow recession. The reason for consumption to hold up well in 2000/2001 was that households were able to go deeper into debt. But with tighter lending standards today and with household balance sheets being extremely stretched, it is unlikely that households will be able to increase their borrowings significantly in order to sustain their already excessive consumption. In fact, with household wealth no longer rising I would expect that households will begin to save again, which will occur at the expense of consumption and overall GDP growth. If we look at the trend of household spending and residential construction as a percent of GDP, we note that a downtrend ended in 1982 at 64% (see Figure 10). After that, spending and residential construction trended up and hovered around 72% of

GDP between 1987 and 2000. Thereafter, spending and residential construction soared to almost 78% of GDP – significantly above the long term trend. This "excursion into prosperity" or over-consumption based

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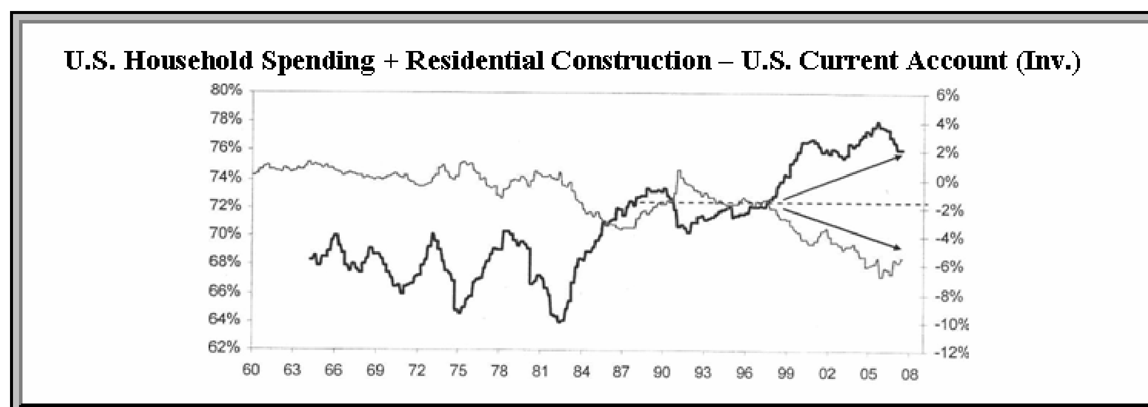
on additional debt also led to the increase in the current account deficit (see Figure 10). In turn, the increase in the US current account deficit led to excessive international liquidity, which however, is no longer growing at an accelerating rate.

Figure 10: Over-consumption leading to a Soaring Current Account Deficit



Source: Bridgewater Associates

Whenever international reserves are growing at a decelerating rate (as would seem to be now the case due to the decline in the US current account deficit) there is a relative tightening of international liquidity, which is negative for all asset markets but US dollar supportive. In particular I should like to reiterate my view that emerging stock markets (India, China, etc.) and industrial commodities (including now oil) are particularly vulnerable under these conditions.

I have pointed out before the correlation between the Baltic Dry Index and the Chinese stock market. In fact, there is a positive correlation between commodity prices, emerging stock markets and the Baltic Dry Index. They tend to increase and decline in concert. The recent 40% collapse in the Baltic Dry Index should, therefore, not be taken lightly (see Figure 11).

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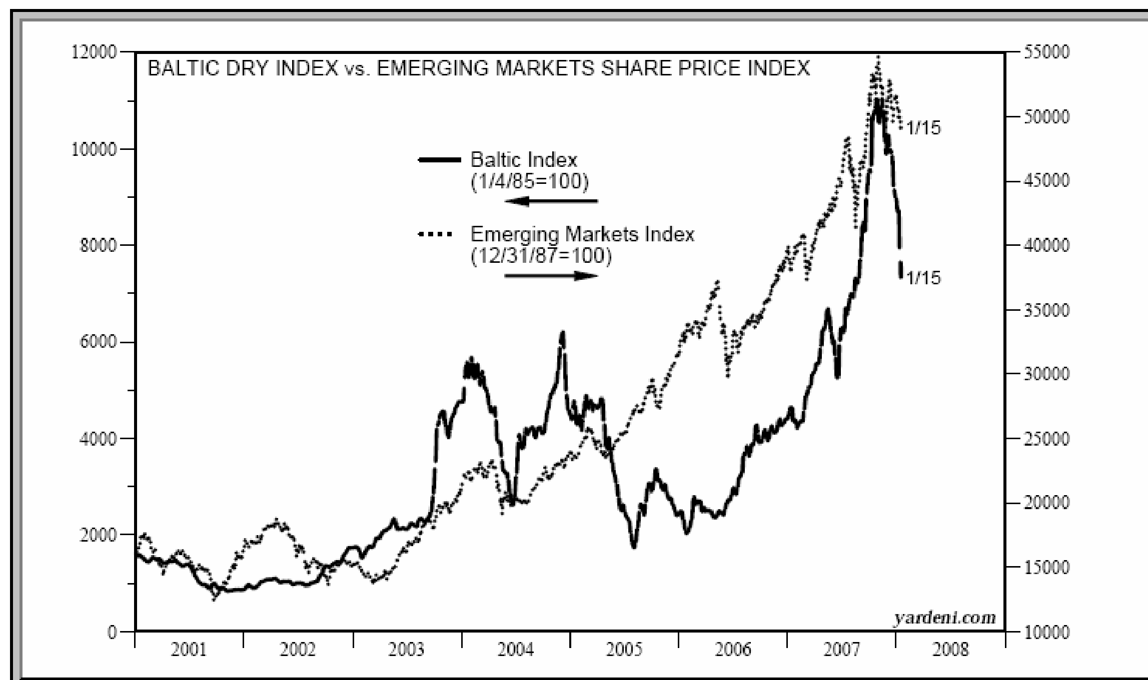
Figure 11: Baltic Dry Index, 2001 – 2008



Source: Ed Yardeni, www.yardeni.com

I have to point out that a bear market occurs amidst strong sector rotation. Homebuilders were the first sector to enter a downtrend starting in June 2005. Sub-prime lenders followed after July 2006. Then, in 2007, financial stocks began to collapse. At the same time, emerging stock markets, commodities and momentum stocks like Apple, Google, Research in Motion etc. continued to soar. In my opinion these last pillars of strength are now the most vulnerable sectors of the equity markets and should be avoided.

I should like to add a final thought about the widespread "bearish sentiment", which is supposed to be from a contrarian point of view positive for equities. According to an "InvestmentNews" online survey of advisors, most investment advisors told their clients to stay the course and hold on to their stocks as the stock market sold off in January. Two-thirds of the respondents - 65.1% - said they were not making any changes to their clients' allocations to equities in light of economic and stock market events that have occurred since the start of the year. But 18% of the respondents said they would increase those allocations and 16.9% said they would decrease them. If we are in a longer term bear market, which I believe is quite likely, investment advisors and clients will have to follow

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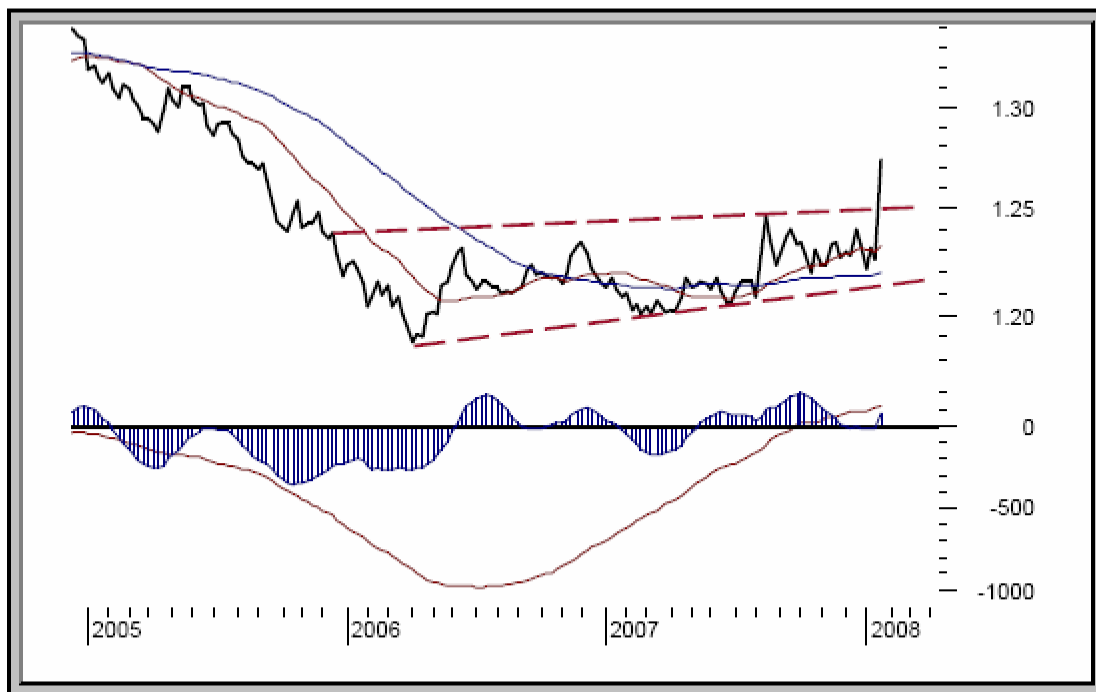
their bearish sentiment with action, which would mean widespread selling!

I have explained in earlier reports that while I am not positive about US equities I believe that US stocks could outperform foreign markets for a few months as foreign markets are likely to decline more than the US market. This process seems to have begun now (see Figure 12).

Figure 12: MSCI US Relative to MSCI World, 2005 – 2008



Source: www.credit-suisse.com/techresearch

I noted above that at the end of January 2008, equity markets had become extremely oversold. For the S&P 500 a relieve rally toward 1450 is possible and would offer an excellent opportunity to reduce positions.

As always, an exposure to gold is recommended as well as a long exposure to US dollars with a tight stop.

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