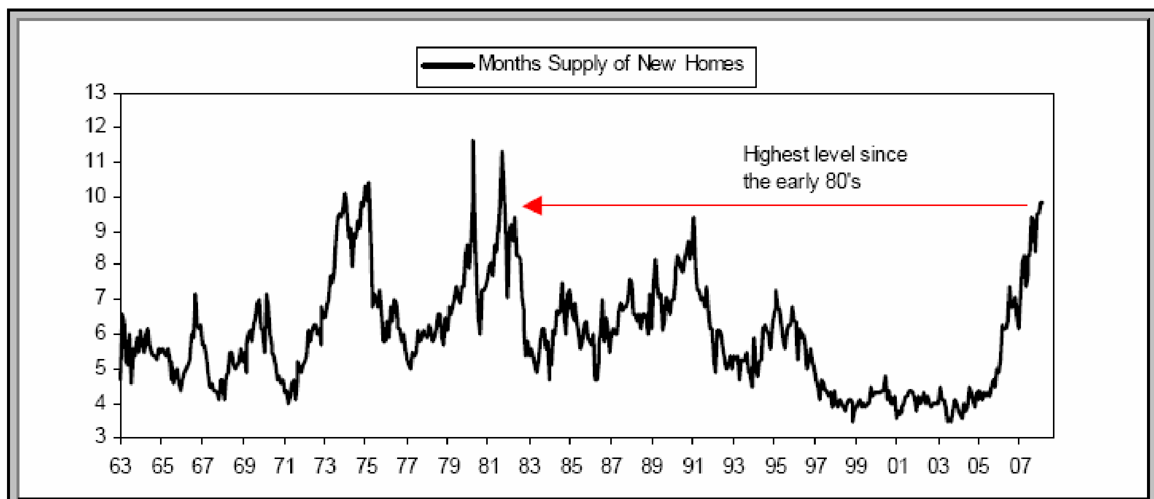
Why do Stocks Rally on bad News?

"When the Fed is the bartender, everyone drinks until they fall down".
Bob Hoye

There is no doubt that the economic news in the US is far from encouraging. Consumer confidence has tumbled, numerous companies such as Starbucks and UPS are reporting that conditions are the worst they have seen since the 1990 recession and the housing market is a total disaster with worse yet to come. Housing starts continue to exceed new home sales with the result that the supply of new homes is at its highest level since the 1981/82 recession. And the supply of new homes is still rising! (See Figure 1)

Figure 1: Record Supply of New Homes



Source: Bridgewater Associates

How bad the conditions are in the housing industry is visible from the number of foreclosures in California, which are up in the first quarter of 2008 by more than 4-times year-on-year (see Figure 2).

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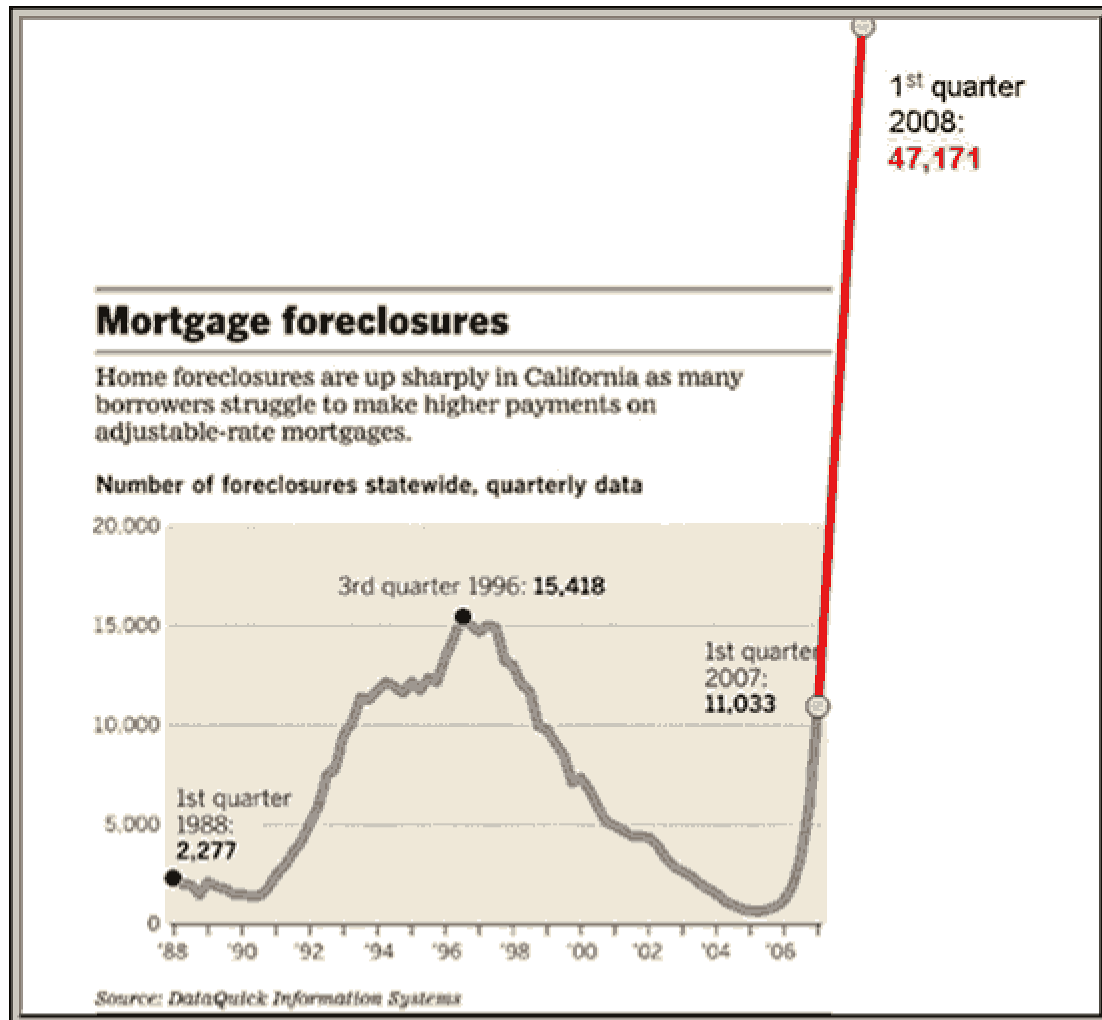
Figure 2: Mortgage Foreclosures in California, 1988 - 2008



Source: The Los Angeles Times

What is interesting about Figure 2 is that in the last downturn in Californian real estate "foreclosures" reached a record in 1996 when "**the Cumulative Real Change** of Southern Californian Median House Prices Since 1982" declined below zero (see also Figure 3, which we published already in last month's report). Since we can expect "the Cumulative Real Change of Southern Californian Median House Prices Since 1982" to also move in the current downturn toward zero or below zero, it would seem that foreclosures will continue to increase no matter what monetary measures the Fed implements!

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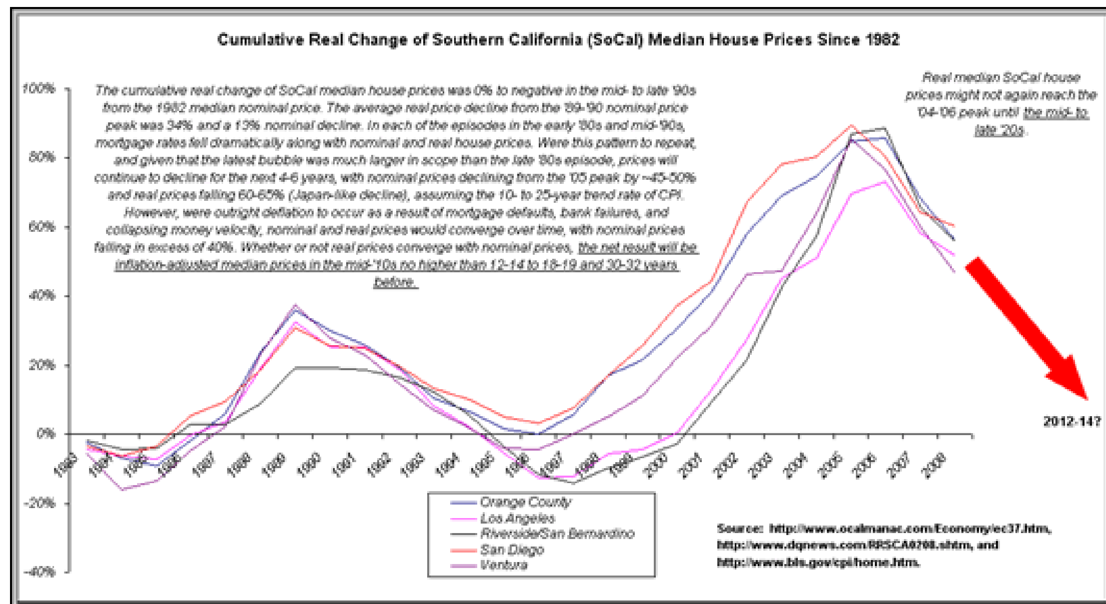
Figure 3: Cumulative Real Change of Southern Californian Median House Prices since 1982



Source: Bruce Carman

According to David Rosenberg of Merrill Lynch, the recent "precipitous" price drop in housing has failed "to elicit any pickup in sales. It is clear to us from the latest new home sales report that the residential housing market is nowhere close to the bottom. In spite of much lower prices, sales failed to pickup and the inventory situation worsened. Moreover, **sales are running significantly below the pace of housing starts**, which reinforces our view that starts have to fall further before the inventory situation will be addressed in any meaningful way." I may add that so far the media has focused on the dire conditions in the housing market and the plight of homebuilders. However, we should also expect the commercial property market to come under pressure because of reduced demand for space by the retailing and the financial sector. One forecast I am reasonably comfortable with is that for the next few years architects will have a very rough time. According to the American Institute of Architects (AIA), which publishes the Architecture Billing Index (ABI), the March ABI fell to 39.7 - its lowest level since the survey was commenced (see Figure 4).

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Figure 4: Architecture Billings Index, 1996 - 2008

Source: Fred Richards, Strategic Investing

It is clear that the downturn in housing is not only having an impact on the homebuilding industry but is spreading to numerous other sectors of the economy such as retailing (see Figure 5), housing related business services and through the credit crisis to the entire economy. As Gail Dudack observed, "job losses in construction, manufacturing, trade-transportation & utilities, professional & business services, financial activities and information technology are overwhelming the gains seen in education & health services, government, leisure & hospitality, mining and other services". This is important because when the unemployment rate increases default rates also increase. I would, therefore, expect loan losses at financial institutions to rise substantially over the next 12 months or so. This is especially true in an environment in which credit spreads have widened as much as they have over the last six months (see Figure 6).

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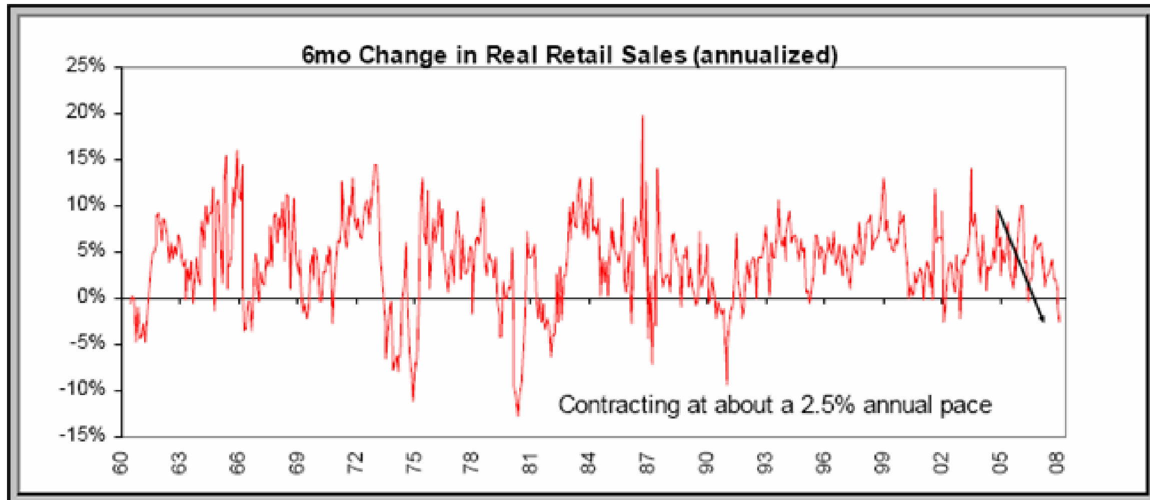
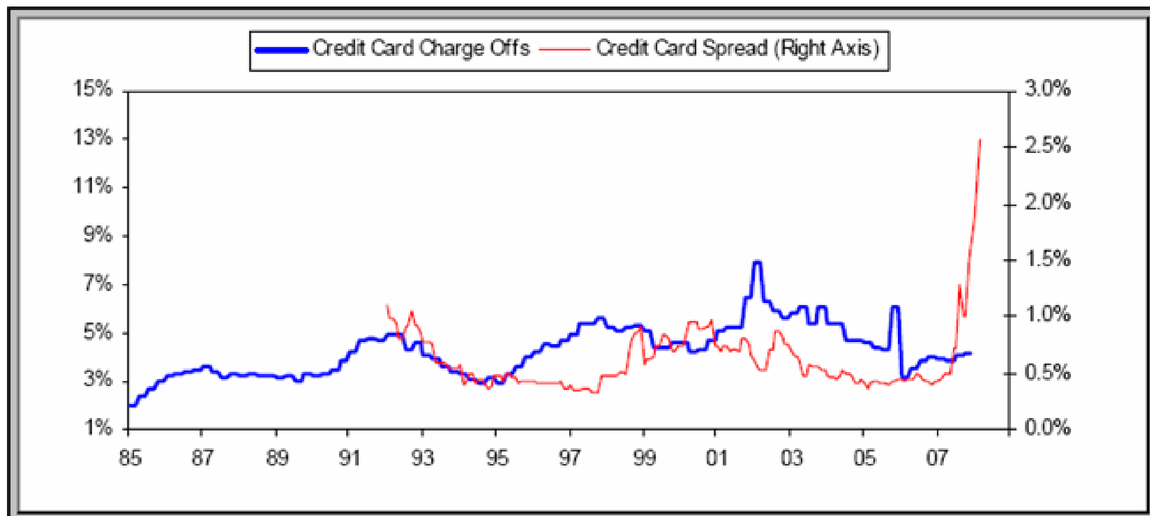
Figure 5: Contracting Retail Sales in Real Terms



Source: Bridgewater Associates

Figure 6: Another Shoe to Drop: Credit Card Default Rates!



Source: Bridgewater Associates

As an aside, Target, the second-largest US discount chain, which is reputed to run one of the tightest ships in the business in their credit card operations, just announced that it wrote off 8.1% of its credit-card loans in March compared to 6.8% in February and that it is in negotiation to sell half its credit-card loans (thirty-day delinquencies are at their highest rates since 2001). As for so many other companies, the credit card

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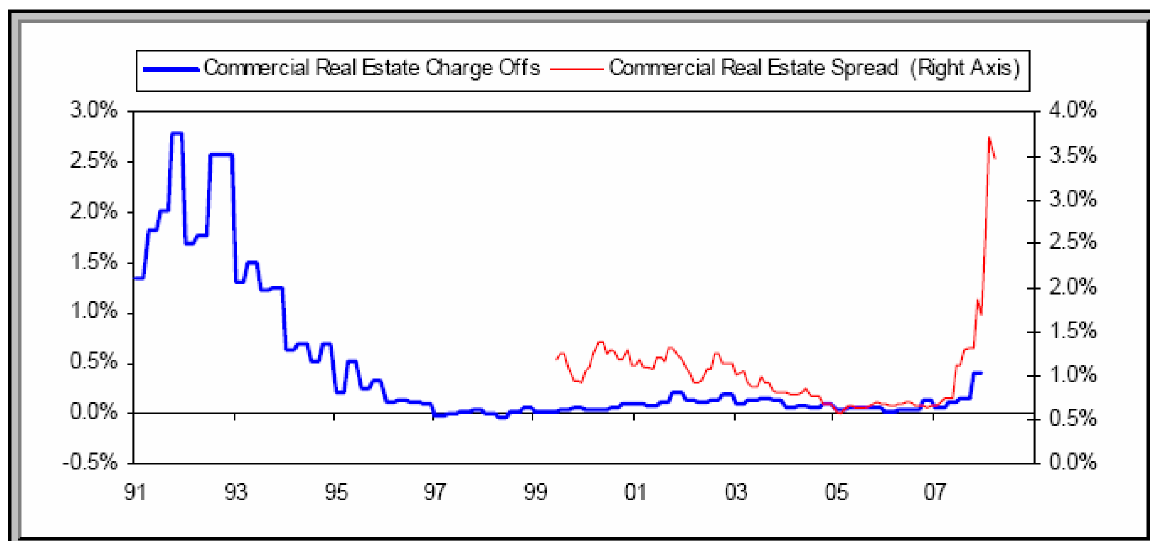
portfolio of Target was the main driver of earnings. Fourth-quarter revenue from Target's credit-card portfolio had jumped 21 percent to $532 million, significantly outpacing the company's total earnings gain of just 0.8 percent (another reason to be skeptical about a strong corporate earnings rebound in the second half of the year and in 2009).

I mentioned above that we should also expect the commercial property market to come under pressure because of reduced demand for space by the retailing and financial sector. Considering how commercial real estate spreads have widened, commercial real estate default rates are likely to increase over the next 12 two years very substantially (see Figure 7)

Figure 7: A Further Shoe to Drop: Loan Losses on Commercial Real Estate



Source: Bridgewater Associates

Since real estate related loans have risen over the last 15 years from 28% of total bank loans to currently over 60% additional meaningful loan losses related to construction and commercial real estate should be expected. In short, the economic news is horrendous and is likely to get much worse over the remainder of the year. In the past, the prevalence of so much bad news was associated with major market lows after major bear markets such as in 1974, 1982, and in 1990 and provided outstanding entry points into the equity markets. However, what makes the present situation unusual is that aside from financial stocks the stock market is hardly down since the beginning of 2007. As I explained in last month's report the stock market seems to think that we are presently

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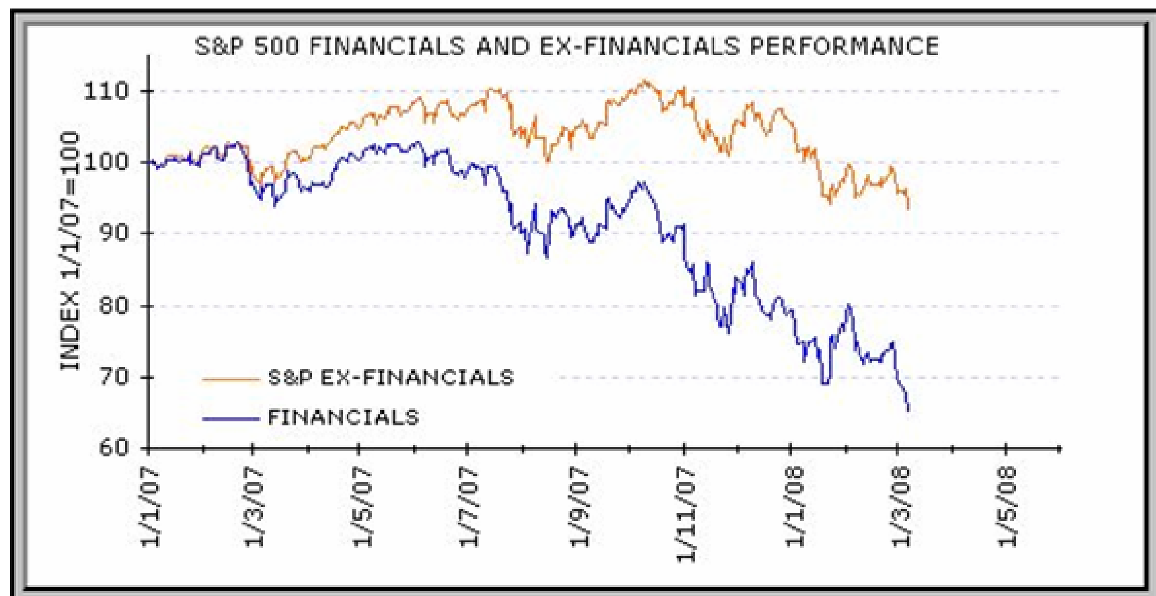
dealing with a financial crisis which is now already largely behind us and which should affect the economy only moderately (see Figure 8, which I am republishing from last month's report for the benefit of our new readers).

Figure 8: Ex Financials the Stock Market has held up!



Source: Morgan Stanley

As a result of the belief that the "worst is behind us", and for other reasons I shall explain below, market participants have remained, while not exuberantly bullish, so at least complacent and optimistic about an economic and corporate profit recovery in the second half of the year and in 2009. According to a recent survey by Barron's (see Barron's of April 26, 2008), institutional investors are heavily leaning toward the positive side. 50% of the respondents were either "very bullish" (7%) or "bullish" (43%) about the US stock market whereas only 12% of respondents were "bearish" (nobody was "very bearish" – see Figure 9).

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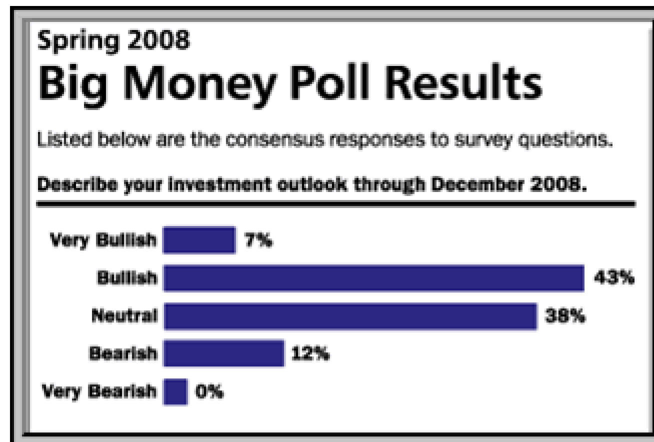
Figure 9: Barron's "Spring 2008 Big Money Poll Results"



Source: Barron's

There were another two interesting aspects regarding the "Spring 2008 Big Money Poll Results." Institutional investors tended to be positive about equities (87% indicated they would be buyers of equities in the next three to six months), very positive about the US dollar and "very bearish" about US Treasuries, and "bearish" about real estate, gold, and oil (see Figure 10).

Figure 10: Favorite and Unpopular Asset Classes

Are you bullish, bearish or neutral about the following assets?

	Bullish	Neutral	Bearish
U.S. Treasuries	3.6%	34.2%	62.2%
Corporate Bonds	33.3	45.0	21.6
U.S. Dollar	45.5	33.0	21.4
Oil	20.7	34.2	45.0
Real Estate	8.1	44.1	47.7
European Stocks	19.8	60.4	19.8
Asian Stocks	41.4	39.6	18.9
Latin America Stocks	42.2	44.0	13.8
Gold	21.6	31.5	46.8
Cash	10.1	67.0	22.9

Source: Barron's

Moreover, institutional investors' favorite industries over the next six to 12 months were "Financial" and "Technology" (see Figure 11).

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Figure 11: Favorite and Unpopular Industry Sectors

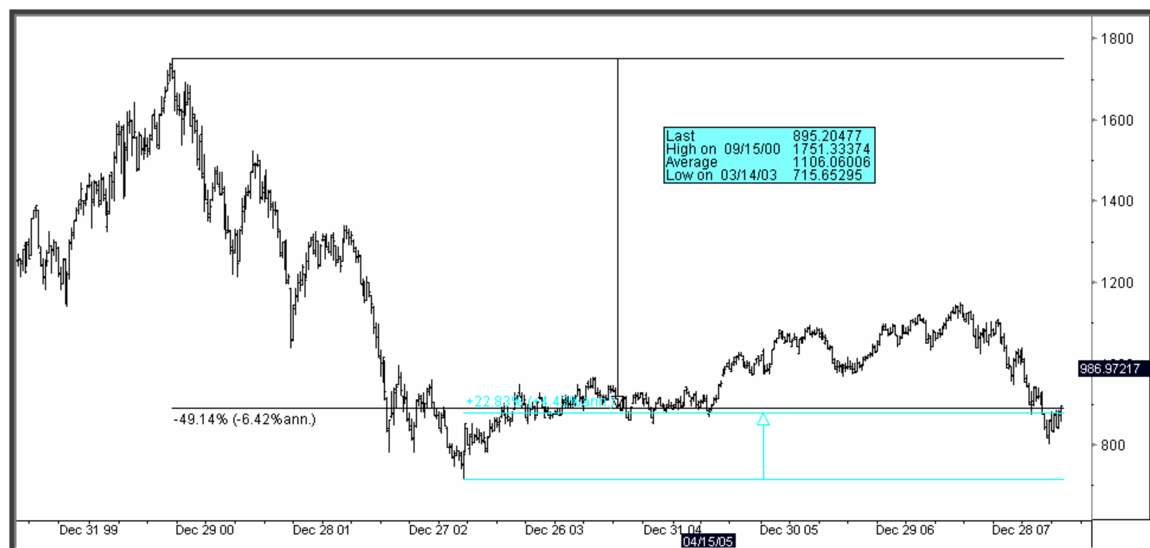
Industry leaders and laggards for the next 6-12 months

	Leaders		Laggards	
	No. 1	No. 2	No. 1	No. 2
Basic Materials	8.8%	3.5%	16.5%	20.0%
Capital Goods	6.1	4.4	3.5	5.2
Consumer Cyclical	4.4	12.3	23.5	23.5
Consumer Staples	7.9	5.3	7.8	3.5
Energy	11.4	14.9	17.4	8.7
Financial	27.2	21.1	13.9	6.1
Health Care	8.8	13.2	1.7	6.1
Technology	21.1	18.4	0.9	4.3
Transportation	2.6	1.8	6.1	5.2
Utilities	1.8	0.9	8.7	13.9

Source: Barron's

To some extend I can understand why US institutions are positive about US equities and the dollar, and bearish about treasuries. Because of the US dollar's steep decline since 2001 US equities are in Euro terms still 50% below the peak in 1999 (in Euro terms - see Figure 12).

Figure 12: S&P 500 in Euro Terms, 1999 - 2008



Source: Bloomberg

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So, in Euro terms, US equities are relatively inexpensive.
In addition, because US equities sold off less than foreign markets since October 2007 they have begun to out-perform foreign markets (see Figure 13).

Figure 13: MSCI US versus MSCI World

Source: www.credit-suisse.com/techresearch

Then, as Walter Bagehot (who edited the Economist for 17 years) already remarked in the 19th century, "John Bull can stand many things, but he cannot stand 2%." So, I have some sympathy with the positive stance of institutional investors. **However, I find it difficult to reconcile financial institutions very negative stance toward Treasuries (only 3.6% of respondents were bullish versus 62.2% who were bearish) and at the same time their positive stance toward the economy and equities. The reason I think there is an inconsistency here is that if interest rates increase (Treasuries decline in value) the highly leveraged consumer and with him the entire economy are unlikely to recover.**

I am grateful to Bill King who publishes an outstanding daily market up-date (mking7@bloomberg.net) for having attracted my attention to Dr.

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Steve Keen, an economist at the University of West Sydney who happens to know a little about debt deflation. According to Keen,

"Fragility is indicated by the proportion of GDP needed to service debt; the higher this proportion is, the less there is available to both consume and invest. Economists habitually excuse any private borrowing on the assumption that it will lead to increased output, and thus finance itself. But 90% of the debt incurred in the past 3 decades has financed speculation rather than investment. Productive capacity has risen far less than debt, so that the debt ratio has grown exponentially.

All major OECD nations (except France) have experienced rising private debt to GDP ratios over the past 3 decades. Australia's debt ratio rose 4.2% faster than GDP for the past 44 years—taking our ratio from 24% in 1964 (and 43% in 1977) to 165% now. The UK's private non-financial debt ratio was 96% in 1977, versus 243% now; the USA's was 93% excluding finance, and 108% including, in 1977; today it is 170% excluding finance, and 282% including.

These levels are unprecedented. **The US private non-financial debt to GDP ratio was 150% in 1929—20% below today's level (it peaked at 215% in 1932, due to Great Depression deflation of 10% p.a., and falling output of 13% p.a…**(emphasis added)

Recoveries from other financial crises in the post-WWII period have worked because they have reignited the growth in private borrowing. I doubt that there is any further capacity to do this: there are no sub-subprime borrowers to whom to lend. The growth in debt levels and asset prices will reverse, and the change in private debt will therefore subtract from demand rather than augmenting it" (see Figure 14).

In essence Keene shares similar concerns as I do. As Bridgewater Associates notes "consumers who are up to their eyeballs in debt remain unresponsive to lower interest rates" (see last month's report and in particular Figure 3 of that report)….. According to Bridgewater Associates, **"this is another indication that we are in a 'deleveraging' environment, not a normal recession.**

We continue to see this in the credit numbers as well…. mortgage lending is down by about $1 trillion from the peak in the latter portion of last year and business borrowing has dropped by about $600 billion from the middle of last year. Less borrowing means less spending" (emphasis added).

The larger problem, however, is that in all Anglo-Saxon countries "consumers are up to their eyeballs in debt" and that the problem of

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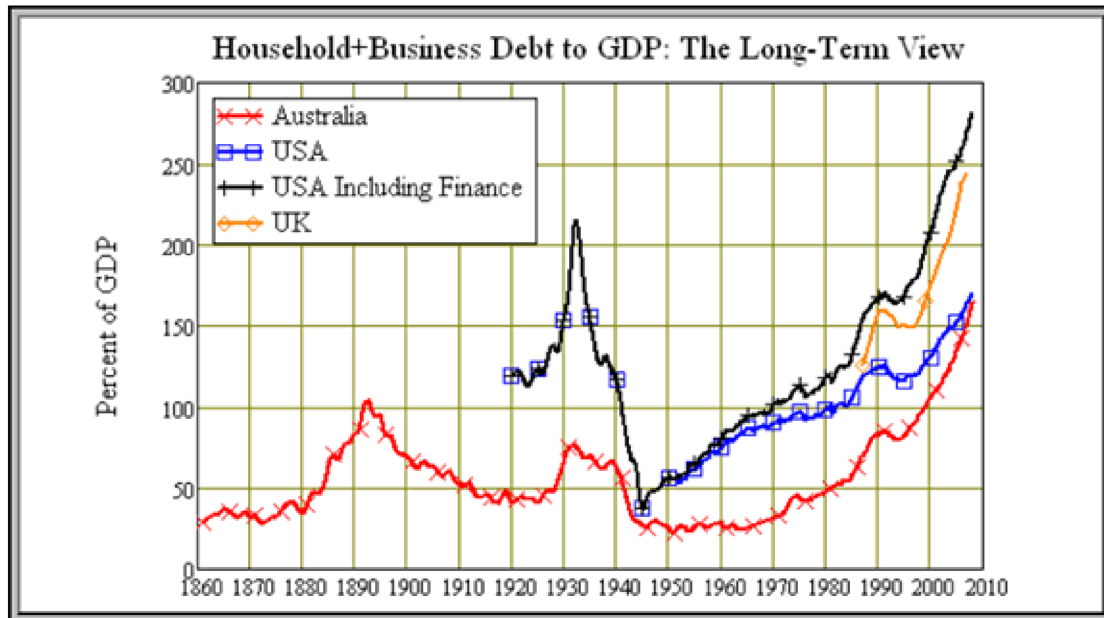
excessive debt is not endemic to the US but exists in all OECD countries (certainly for the household sector – please note that Figure 14 aggregates household and business debt).

Figure 14: Household & Business Debt to GDP



Source: Steve Keen, http://www.debtdeflation.com/blogs/

So, what we are dealing with is not just a US credit bubble but a US credit bubble, which has spread around the world and inflated almost all asset markets into the stratosphere. In fact, some asset markets became or are still far more inflated than US equities. I am thinking here of Chinese and Indian equities and of real estate in Spain, the UK, Ireland, and Australia where property prices are still rising – at least in Melbourne and especially in Perth (see Figure 15).

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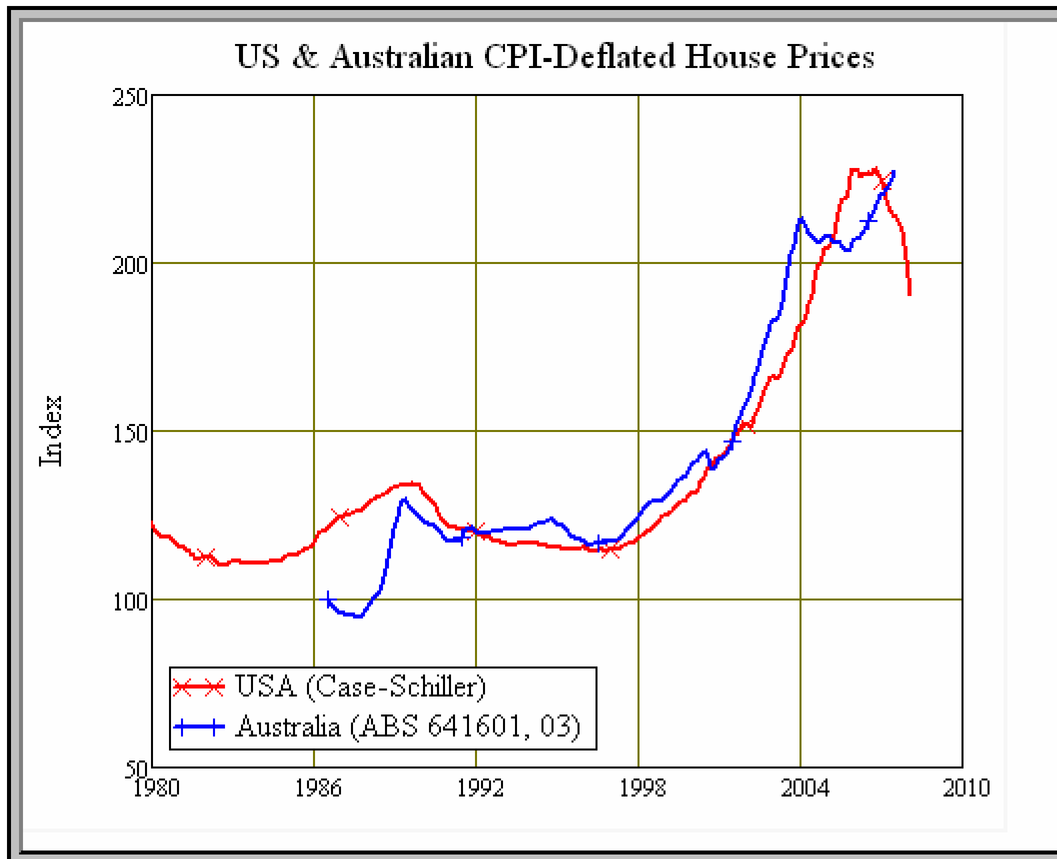
Figure 15: Real Home Prices in the US and Australia, 1980 - 2008



Source: Steve Keen, http://www.debtdeflation.com/blogs/

As an aside, prime UK commercial property prices in the South-East have slumped by around 25 per cent in the past two quarters, with yields hardening from 4.5 to six per cent, an unprecedented shift in property values estimated at a one in 15,000 year probability, according to one of the UK's top property consultants Strutt & Parker! (In the first quarter, Strutt & Parker saw its own revenues tumble by more than half, which is far better than the collapse in the UK commercial property market to just 25 per cent of turnover in Q1 2007.) At a recent event in Dubai Andy Martin, the head of Strutt and Parker's Commercial Division, was asked the question: "did this make UK commercial property a buy?" he gave the obvious answer: "Only if you think the impact of the crisis on occupancy will be zero!"

Aside from artificially low interest rates on US short dated Treasuries, excessive optimism regarding an economic and profit recovery in the second half of 2008 and in 2009, and dollar weakness, there are two more reasons why US equities have held up well in face of deteriorating

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economic news. “Extraordinary monetary measures” by the Fed, which drove real short-term interest rates into negative territory, have propelled commodity prices higher (especially energy and agricultural commodities) and boosted the shares of energy, industrial and material stocks, which make up 14%, 12% and 4% of the S&P weight respectively, far above their previous highs in 2007 (see Figure 16).

Figure 16: US Steel, 2003 - 2008

Source: www.decisionpoint.com

In addition, since households have to spend an increasing portion of their income on non-discretionary items (necessities such as food and energy), consumer staple companies, which make up 11% of the S&P 500, have also been strong (see Figure 17)

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Figure 17: Wal-Mart, 2006 - 2008

Source: www.decisionpoint.com

Considering all the above mentioned factors, I hope our readers will understand why US stocks have held up so well – at least so far.

I have expressed the view in earlier reports that investors could buy the S&P 500 below 1300 and sell it between 1400 and 1450. Since I expect that the economy and corporate profits will badly disappoint over the next six months and since we are now moving into the seasonally weak period, I would use the current rebound as an opportunity to lighten up on equities (see Figure 18). This applies also to emerging stock markets.

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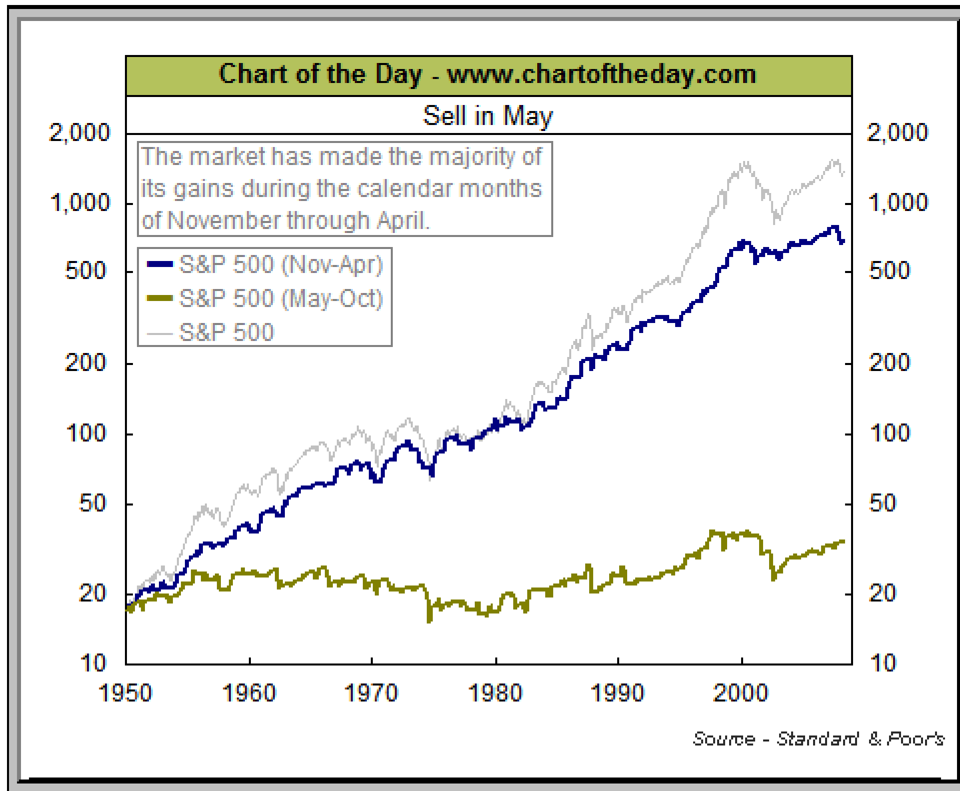
Figure 18: Performance of S&P 500 between November and April, and between May and October



Source: www.chartoftheday.com

Another reason for taking an increasingly negative view about asset markets is that the engines of global liquidity – the US trade and current account deficits – are stuttering. Because consumption of discretionary items is no longer increasing the US trade and current account deficits are no longer expanding. **Hence, while global liquidity is still there, it is no longer expanding at an accelerating rate** (see Figure 19).

Whenever the rate of growth of global liquidity is contracting asset markets become vulnerable while the dollar should – at least in theory – rally. I would, therefore, at least for now, refrain from shorting the US dollar. In fact, I would aside from the Euro also expect commodity related currencies (Canadian, Australian and New Zealand dollar) to weaken for the next few months.

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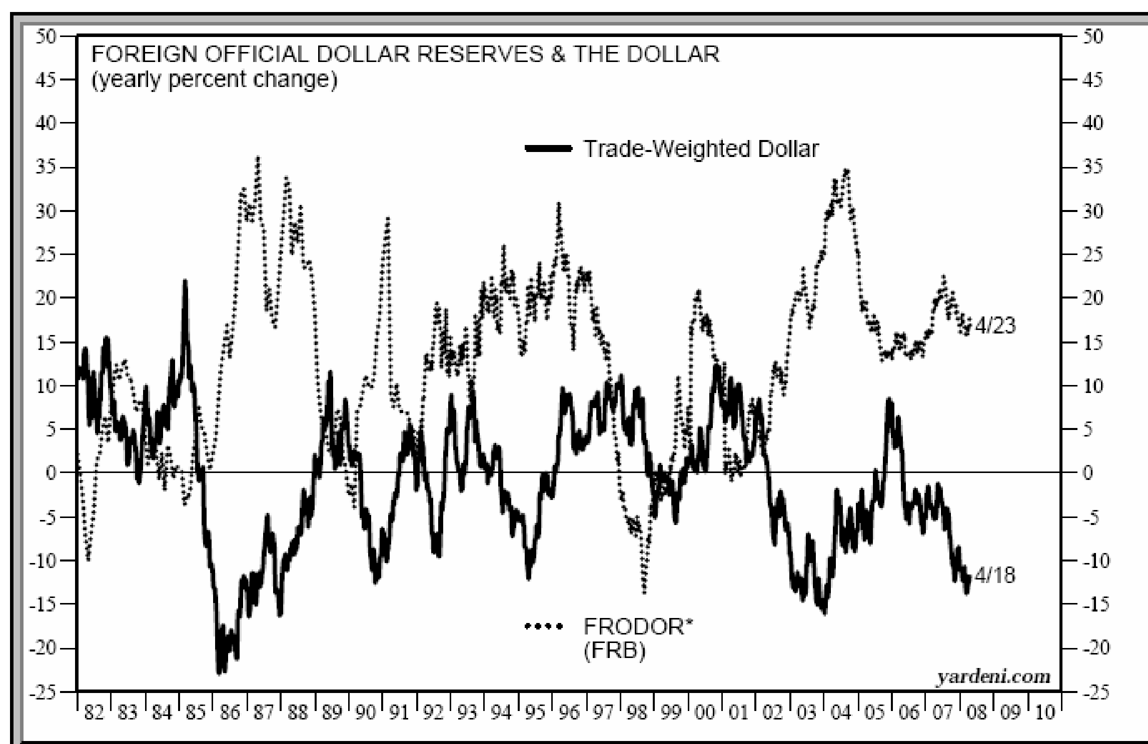
Figure 19: Inverse Correlation between the Growth Rate of FRODOR and yearly Percent Change in Major Currencies!



Source: Ed Yardeni, www.yardeni.com

And while I find it extremely difficult to make a fundamentally strong case for owning the US dollar (it also makes me nervous that so many institutional investors are positive about the dollar – see Figure 10) based on a relative tightening of global liquidity (see Figure 19) a small short Euro position is recommended with a tight stop loss order (see Figure 20).

As an aside, please also note the extended weakness of the dollar since the Fed began to cut rates in September 2007! Mr. Bernanke's monetary policies amount to nothing else but a complete debasement of the currency! But not surprisingly – given the educational levels in the US – Mr. Bernanke receives high marks for how he handled the financial crisis….

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Figure 20: Euro Index, 2007 - 2008

Source: www.decisionpoint.com

Gold is correcting and I hope that its price will retreat further. I would consider any weakness toward $ 800, which is far certain from happening, to be an excellent entry point.

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