Little Good News!

Marc Faber

A reader of this commentary recently criticized me for not having made more specific buy recommendations. He may have a point but I responded that over the last 9 months nothing on the long side really worked (except the US dollar just recently) and that it was a period during which it was far more important to focus on what one should not buy but sell. The reader in question then came back and suggested that stocks like Johnson & Johnson had performed well and that I should have recommended it. I agree. In US dollar terms the stock has performed reasonably well but in Euro terms a different picture emerges (see Figure 1)

Figure 1: Johnson & Johnson in Euro Terms, 1998 -2008

Source: Bloomberg

Still, I have some sympathy for this reader's criticism because I believe that we are, like in the seventies, in a stock and asset picker's market. Volatility will stay relatively high and there will be large moves in individual stocks, sectors and asset classes (up and down). I very much

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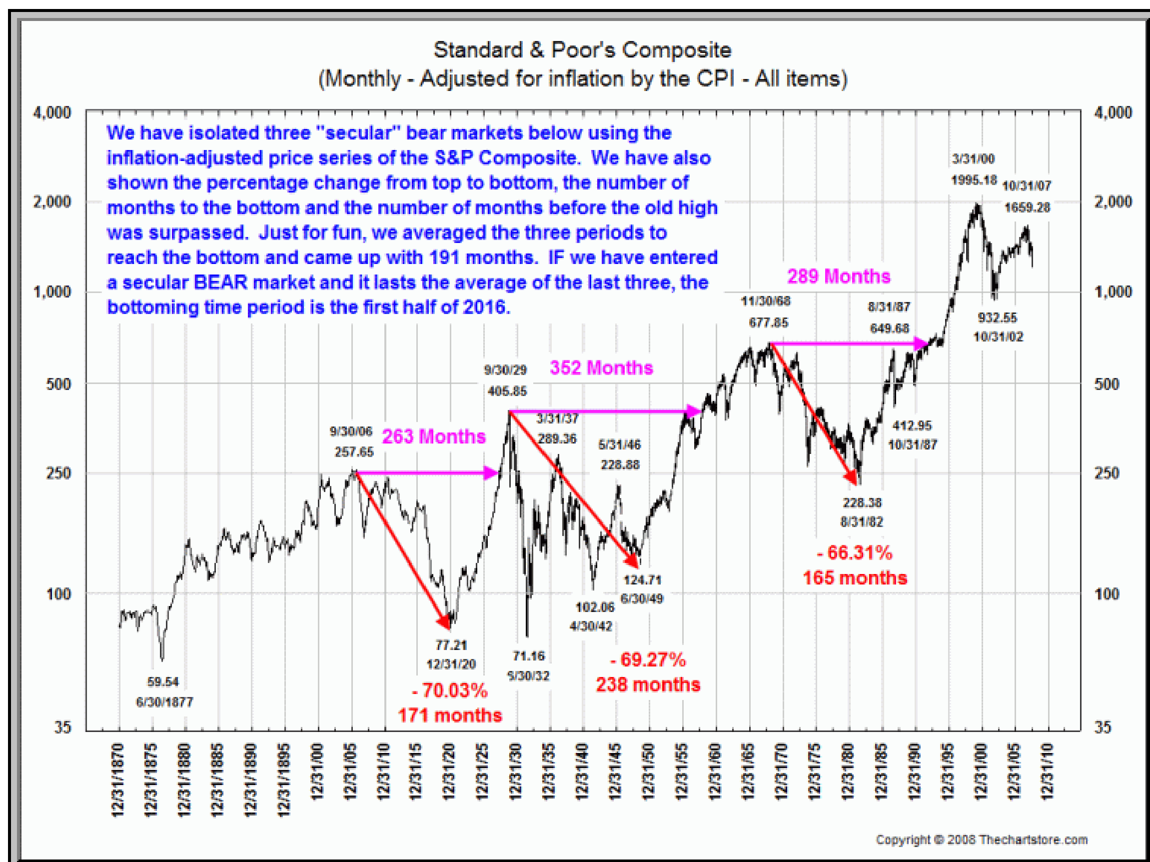
doubt that the major equity indices will make much headway in real (inflation adjusted) terms. In fact, it is far more likely that equities will continue to decline in real terms for quite some time. Ron Griess, who runs the excellent website www.thechartstore.com (highly recommended for a historical perspective of asset markets), notes that there have been three major inflation adjusted bear markets over the last 100 years (1906 - 1921, 1929 – 1949 and 1966 – 1982). The average length of an inflation-adjusted bear market was 191 months (almost 16 years). This observation would suggest the possibility that the US stock market (provided we have entered a bear market in real terms) may only bottom out in 2016 in inflation-adjusted terms (see Figure 2). I need to emphasize that even after the decline of equities in real terms since 2000 the S&P 500 inflation adjusted is still far higher than it was at the peaks in 1906, 1929 and 1966 (see Figure 2).

Figure 2: Inflation-adjusted US Equities still at Extremely Lofty Levels
Real S&P 500, 1870 - 2008



Source: Ron Griess, www.thechartstore.com

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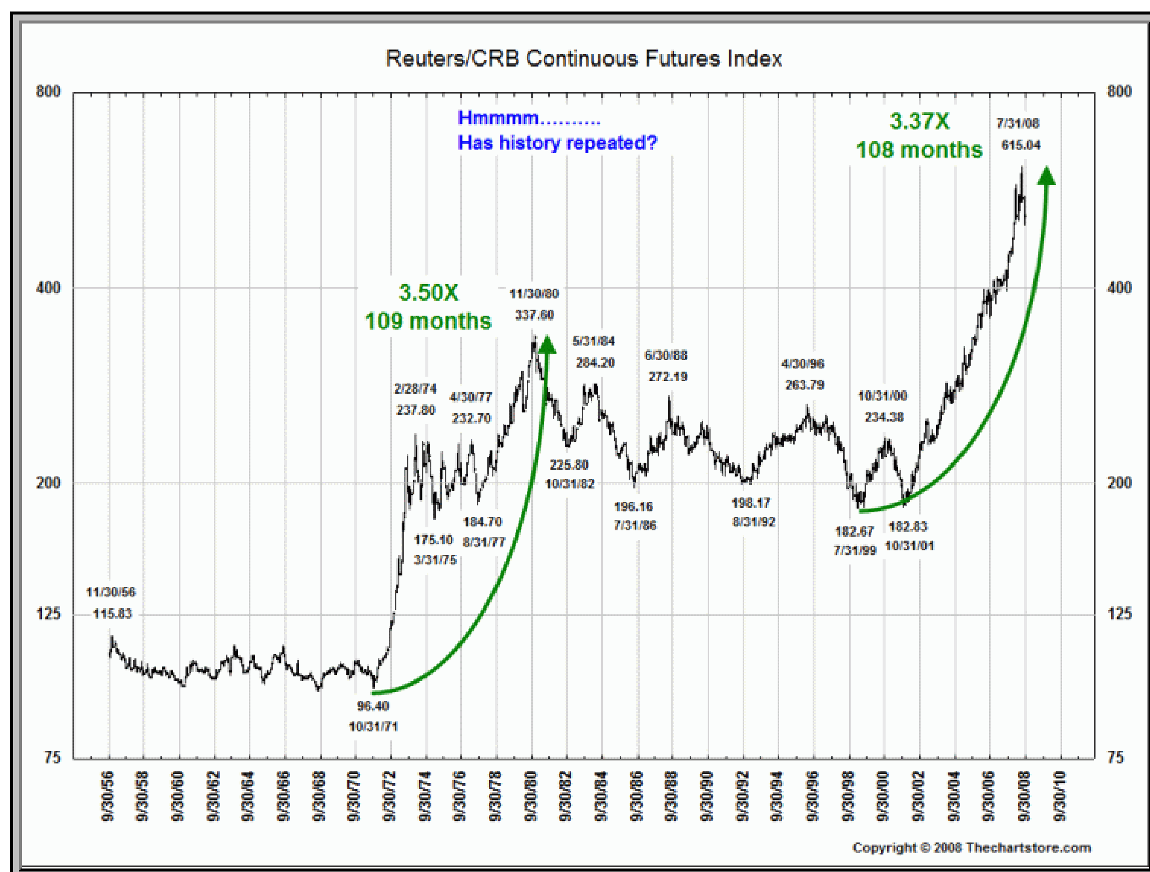
Therefore, it may be possible for Ben, Hank & Co to support asset prices with enormous support measures and all sorts of market manipulations and government bailouts in nominal terms but it is very doubtful that this very questionable group of government officials (a better term is group of "market manipulators" who in recent years completely mispriced the cost of capital through artificially low interest rates) will be able to boost equity prices higher in real terms.

Moreover, whereas I endorse the view that the right selection of a stock will be important for the overall objective of preserving wealth, the key will be the correct asset allocation – as it has been over the last few years. Clearly, the assets to have invested in from 2001 to late 2007 were emerging markets and commodities and not US equities, which badly underperformed world markets until late 2007 (see Figure 3).

Figure 3: Will the Winners of the 2002 – 2007 Global Asset Bubble Continue to Shine?



Source: Ron Griess, www.thechartstore.com

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Now, I am not suggesting that the outperformance of commodities versus the US stock market will continue and my regular readers will know that I have repeatedly suggested that US equities would outperform foreign markets in 2008 and that the second half of 2008 would not be friendly for commodities. But the point I am trying to make is that for the preservation of capital in real terms and hopefully for some capital gains I regard the most important factor to be whether an investor is positioned in cash (in a strong currency or gold), bonds, equities (US, Europe, or emerging markets), commodities, or real estate. After all, it is not very likely that anyone would have more than 10% of his assets in a single stock whereas to have 50% or even 100% of one's assets in USD or Euros would not be a particularly uncommon position.

But I accept my reader's criticism and, therefore, I have here a very specific recommendation: travel to Jordan and Syria as I have just done. This recommendation may not bring you immediate material wealth but may help you better understand the "world" and bring you great personal joy. The Near- and Middle East were one of the cradles of early civilizations and to visit the once upon flourishing and powerful cities like Petra, Bosra, Damascus, Aleppo, Palmyra, Apamea and Antioch (now in Turkey) is a fascinating experience. I may add that the Roman temples in Syria are far more impressive than what you will find in Italy and that the Crac des Chevaliers is undoubtedly the best preserved and most stunning Middle Ages fortress in the world. In fact, Syria is littered with citadels dating back to the Crusader times and with historical and religiously important sites dating back to Biblical times (churches and monasteries). The people are extremely friendly and are, in my opinion, actually quite switched on. Also safety is not an issue, and food and hotels are excellent. The American State Department discourages traveling to Syria but some American tour groups do actually organize trips to this wonderful and actually rather liberal country (religious freedom and promising night life). I strongly encourage everyone to go to Syria, Jordan and also Iran (also a stunning country) to which we traveled three years ago (since Israel and Syria have not yet concluded a peace agreement Israeli passport holders are not permitted to travel to Syria).

Wealth in life comes in many different ways. Wealth is not only the accumulation of material goods, but good friendships, happy family relations, knowledge and memorable experiences. In fact, I believe that if you are happy and remove yourself from time to time from your daily working routine and your Bloomberg terminal and take a more detached look of the world and the investment markets you will achieve better investment results. So, my advice is to make the effort and to travel every

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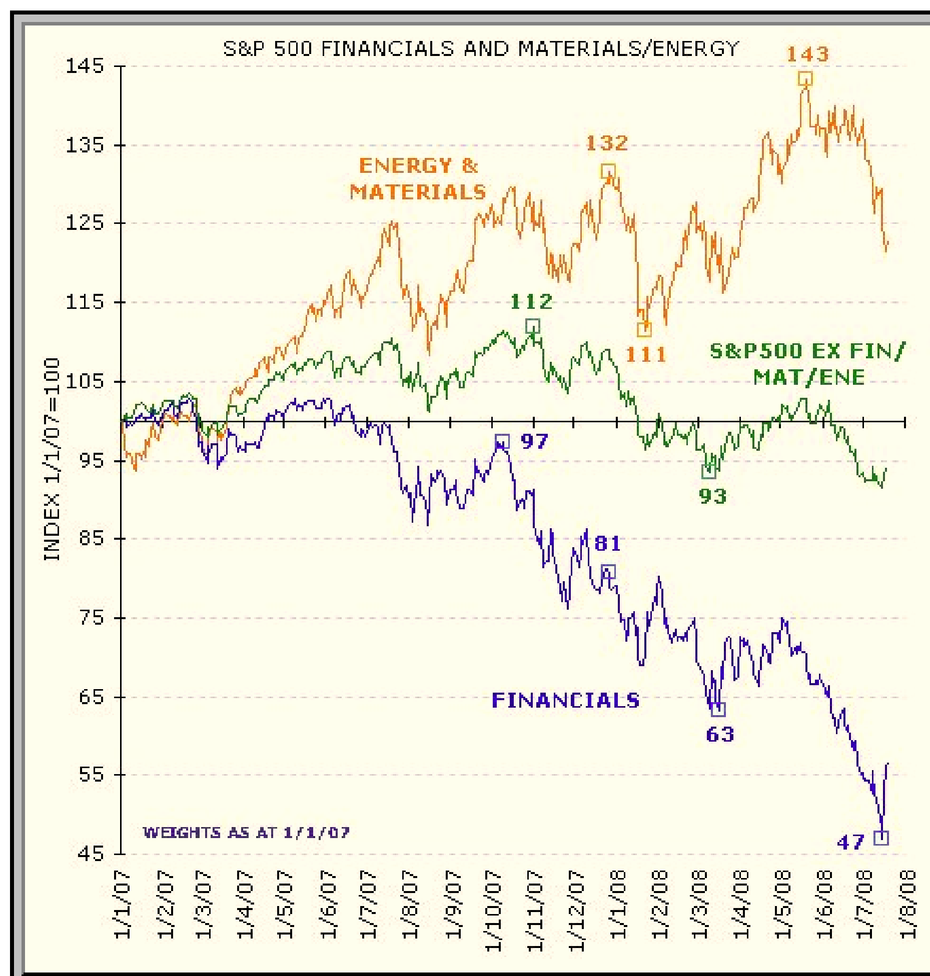
year somewhere where you have never been before and explore the world. You will get a very different impression and a more balanced view from what the Media and the politicians are telling you (at the Citadel of Aleppo – another very impressive fortress - I met a blind Japanese tourist – I admire his courage and will power "never to give up" and the inconvenience for him to travel for the experience).

But back to the investment markets! In recent reports I have argued that some preventive selling of commodity related and material related stocks was advisable in view of the financial crisis spreading into the real economy. My argument was that the bear market in equities would only come to an end with strong sectors like commodity related equities and strong stocks such as Research in Motion, Apple and Amazon.com also succumbing to the weakness in financial stocks (see Figure 4).

Figure 4: Financial Stock Weakness now Spreading to the Rest of the Stock Market.



Source: Gerard Minack, Morgan Stanley

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I have to admit that it has puzzled me for a while that highly cyclical stocks such as of companies related to steel, iron ore, copper and shipping continued to soar in the first halve of 2008 when it was becoming increasingly obvious that the global economy was decelerating very rapidly and that corporate profits would disappoint. But we need to accept the fact that asset markets are increasingly driven by short-term momentum players who need to show month-by-month performance and, therefore, when the majority of stocks decline and just a few stocks appreciate all the "long money" piles into the still rising equities, which then leads to mini bubbles in the last few strong stocks and sectors (see Figure 5).

Figure 5: US Steel (X) – Sell on a Rebound!

Source: www.decisionpoint.com

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I need to stress that it is quite common for highly cyclical companies to perform well at the very tail end of an economic expansion and of a bull market (see Figure 5 and Figure 6).

Figure 6: Cleveland Cliffs (CLF) – Still Considerable Downside Risk

Source: www.decisionpoint.com

But when cyclical companies' stocks begin to break down (including CVRD, Rio Tinto, BHP and Arcelor Mittal) and when industrial commodities sell-off and the Baltic Dry Index collapses (see Figure 7) we have to consider carefully what might be the reason for the breakdown. As I have repeatedly explained in the past, global liquidity is tightening because of the contraction in the US trade and current account deficit. This affects growth in the economies of manufacturing countries (China) far more than the economies of consumers (such as the US) and contains growth in demand for raw materials. In addition, when growth in manufacturing countries slows down it also affects capital spending as investment projects are cancelled (see Figure 8).

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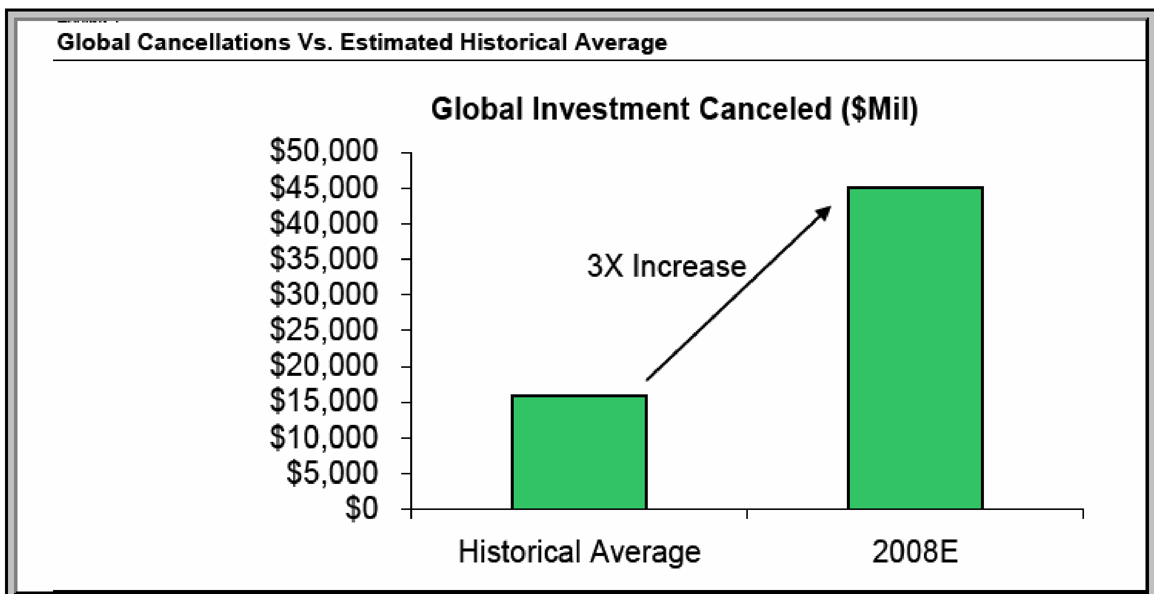
Figure 7: Baltic Dry Index, 2003 - 2008

Source: Bloomberg

Figure 8: Cancellations of Investments = Lower Demand for Commodities



Source: Morgan Stanley

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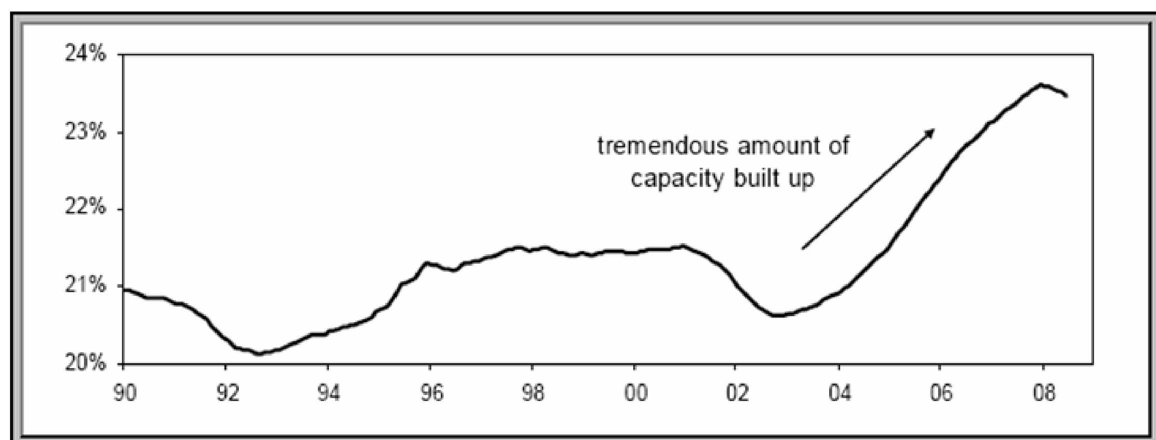
It should be understood that during the global economic expansion (2001 – 2007) the demand for industrial commodities did not only increase because of higher consumption leading to strong industrial production growth but also because significant new investments were undertaken in construction, infrastructure and in order to expand manufacturing capacity. Hence, when demand growth slows down and capital spending no longer increases, industrial commodities and cyclical sectors and cyclical economies (especially emerging economies) are particularly vulnerable. As can be seen from Figure 9, the synchronized global economic expansion since 2001 drove World Fixed Investments to the highest level as a percentage of World GDP for the 1990 to 2008 period (see Figure 9).

Figure 9: World Fixed Investments as Percentage of World GDP, 1990 – 2008



Source: Bridgewater Associates

Considering the cancellations of investments (see Figure 8) and rising excess capacities as a result of slower global economic growth (or more likely because of an economic slump, capital spending could come under more pressure than is widely expected. I should add that in this environment technology stocks, which are in the US over-weighted by institutional investors, are particularly vulnerable (see Figure 10).

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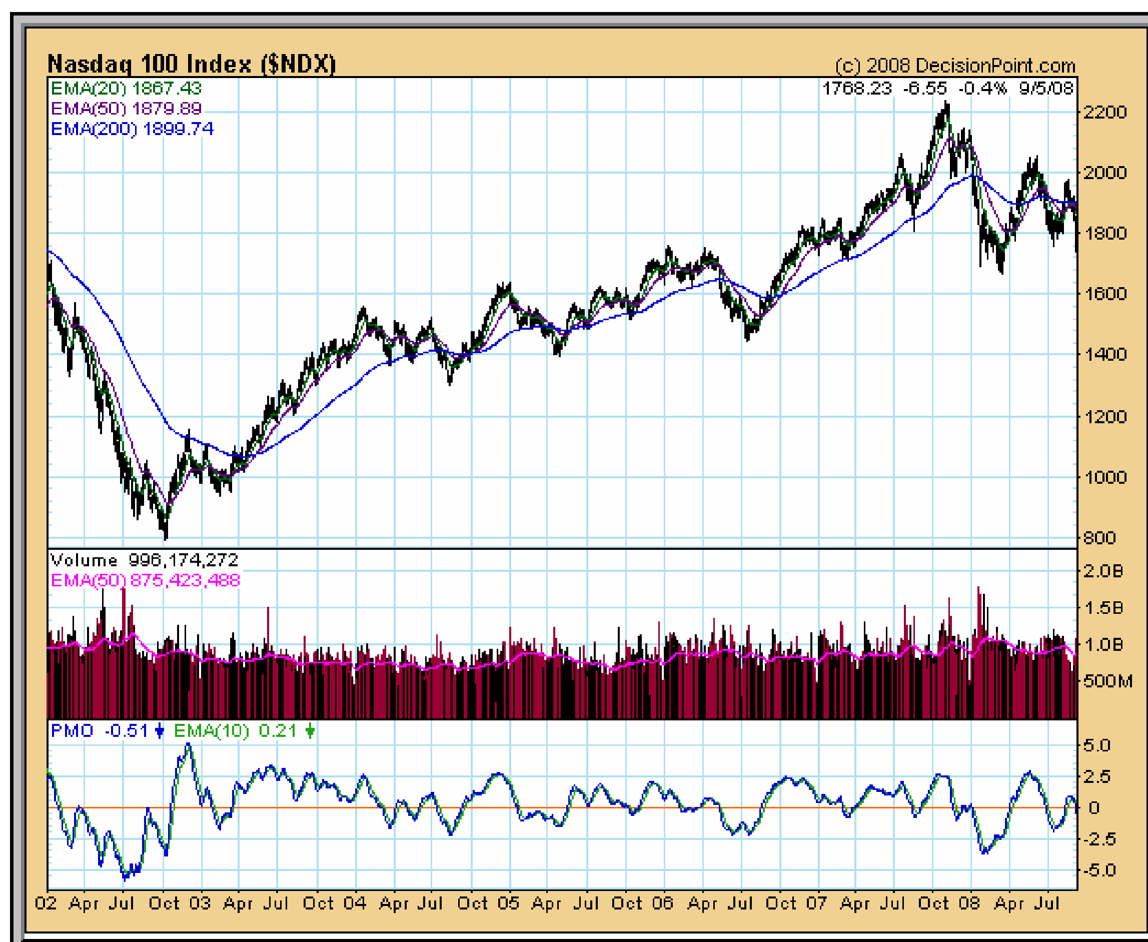
Figure 10: NASDAQ 100 Index, 2002 – 2008: Vulnerable in a Global Economic Slowdown



Source: www.decisonpoint.com

In sum, the global economy is decelerating rapidly, corporate profits are declining and the weakness in financial stocks is now spreading through all asset markets. Still, there is some good news. The US dollar is strengthening (and is now short-term overbought) and some stocks and commodities have become oversold from a near-term perspective. So, what could happen in the next few weeks is a rebound in the Euro, which is oversold near-term, and a rebound in equities and selected commodities. However, I would be careful to bet on such a rebound for the simple reason that from a longer term point of view stocks remain high (see Figure 1) and given the decline in corporate profits they are also far from inexpensive! Furthermore, if I look at asset markets and at individual stocks the downside risks remain rather significant (see Figure 5 and Figure 6). I also need to clarify my stance toward commodities. I believe that we have reached a top in the CRB Index (see Figure 2 and

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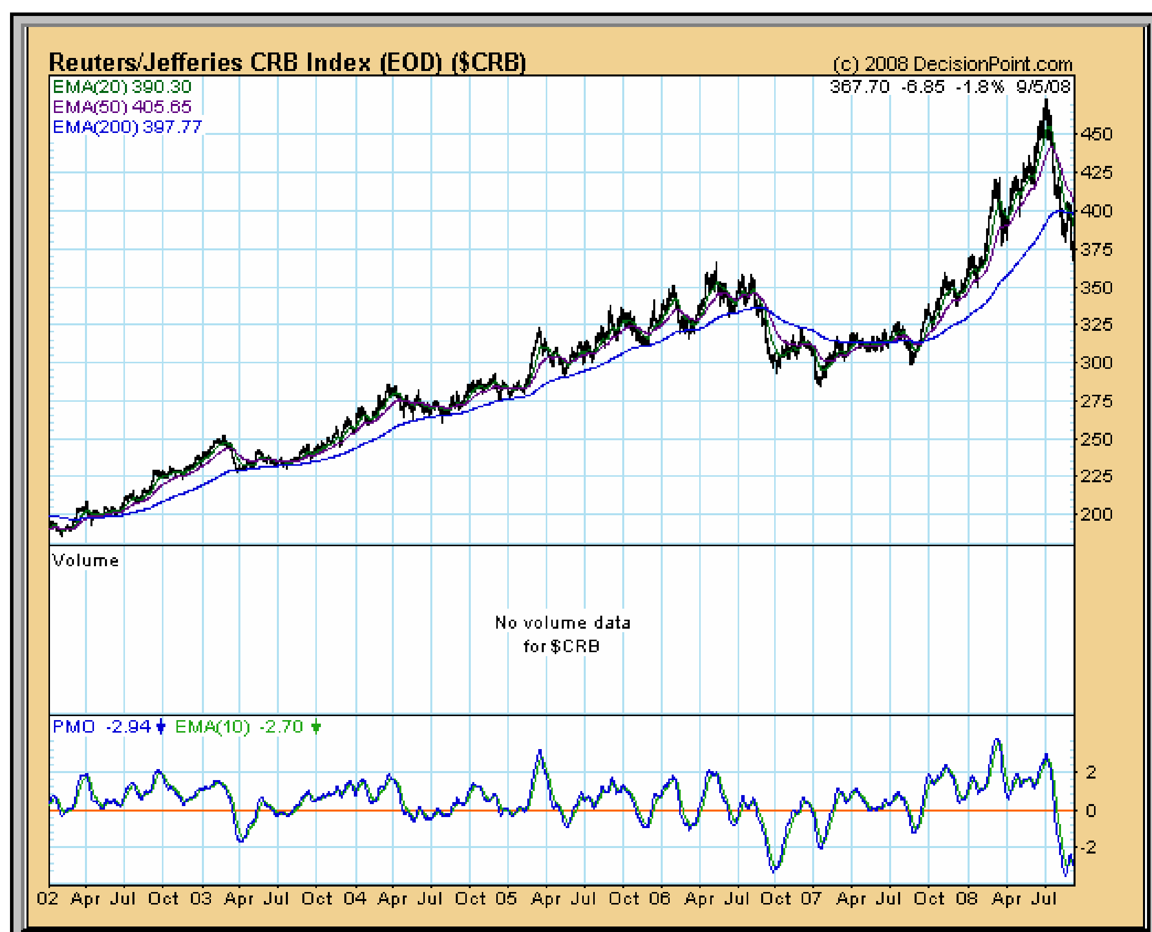
Figure 11). Whether this top turns out to be an intermediate top or will be a longer-term top we do not know. I suspect that at some point money printing by all the world's governments will lead to higher inflation and commodity prices (this assumption would also be consistent with the Kondratieff Cycle). However, we should not forget that the current financial crisis and credit growth slowdown is unprecedented in the last 30 years or so (see Figure 3 of the August 20 report) and that the through of the Kondratieff down-wave, which lasted in real terms from 1974 to 2001, was incomplete because it was not accompanied by a massive debt-liquidation, which should occur at the Kondratieff wave through.

Figure 11: CRB Index – Still Vulnerable!



Source: www.decisionpoint.com

As a result, a deflationary bust originating from debt liquidation should not be ruled out entirely before highly inflationary monetary and fiscal policies around the world bring about very high inflation rates. But that

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may only happen after 2012 and in the meantime all asset markets could continue to suffer badly as credit contracts and liquidity evaporates. In this scenario, gold is likely to shine again at some point.

As indicated above, asset markets and non-US currencies have become near term oversold and could rebound shortly. However, rebounds should be used to lighten positions and to increase US dollar positions. In particular, I would use any rebound in stocks like IBM, Apple, Amazon.com and Research in Motion (see Figure 12) as a shorting opportunity (with tight stops). For individuals the purchase of put options may be a less risky alternative.

Figure 12: Research in Motion (RIMM), 2003 – 2008: Little Upside Potential and Large Downside Risk!

Source: www.decisionpoint.com

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