If Columbus Had an Advisory Committee He Would Surely Still Be at the Dock!

Marc Faber

"Life is a long lesson in humility."

"I'm not young enough to know everything."

James Barrie, author of *Peter Pan: or, The Boy Who Wouldn't Grow Up.*

"There is nothing more deceptive than an obvious fact."

Arthur Conan Doyle (Sherlock Holmes in *The Boscombe Valley Mystery*).

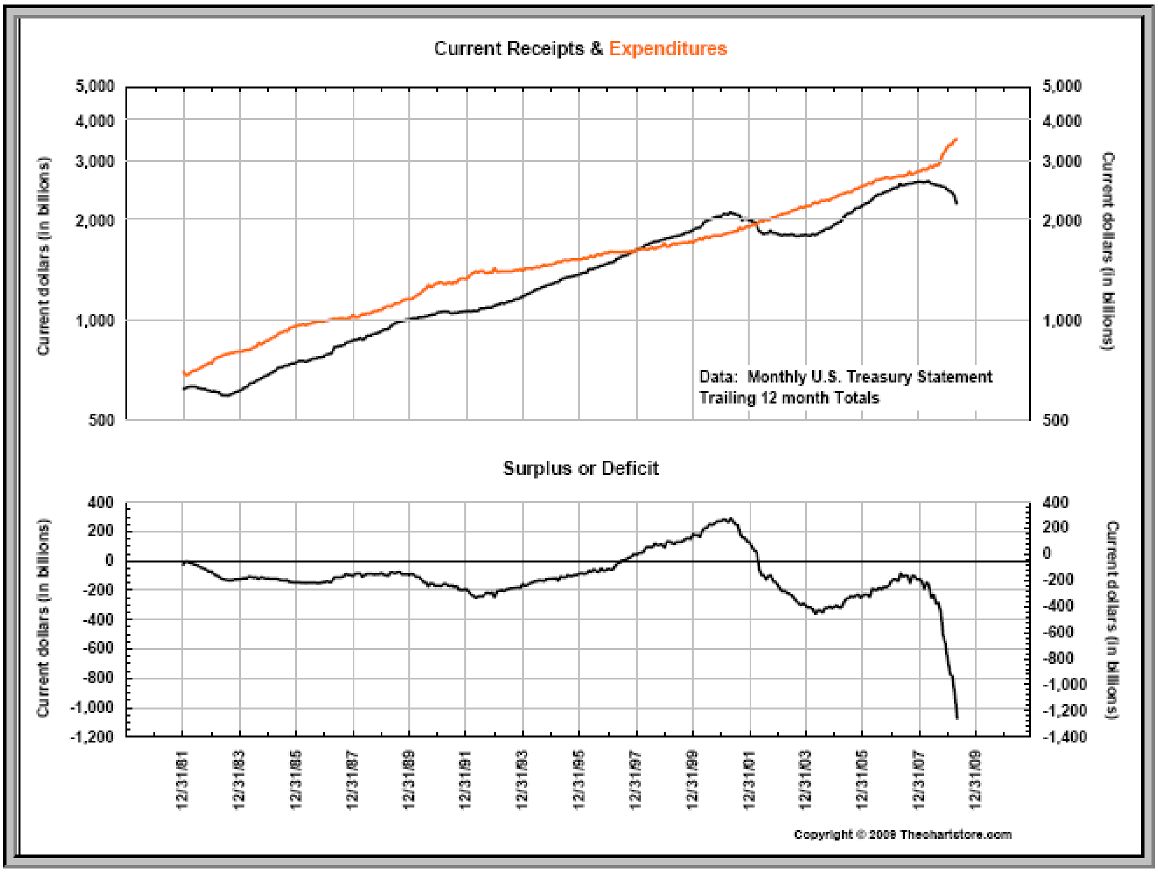
I adopted the title of this report from a quote by Arthur Goldberg ("If Columbus had an advisory committee he would probably still be at the dock."). But I would like to add that had he manned the ship with Ben Bernanke, Tim Geithner, and Larry Summers, the Santa Maria would have sunk right off the coast of Andalusia from where he sailed from the small port city of Palos de la Frontera. When the first storm would have hit, Ben Bernanke would have been pondering over some maps from the dark ages (he is still obsessed by the notion that if flat panel TV sets decline in price it is bad but if postal rates, subway fares and insurance premiums increase it is good), Tim Geithner would have been busy doing shady deals with other crew members, while Larry Summers who would have at the time built the Santa Maria would have been sound asleep when the ship began to leak badly.

I am bringing this up because when watching the three economic policy decision makers one does not gain much confidence. For one, as Paul Volcker pointed out, "***We live in this peculiar world where 3 percent inflation is stability but a half percent decline in the price index is deflation.***"

Then there is this well-established believe among almost everyone that when an unsustainable economic boom is followed by a recession (every boom is unsustainable) the government is supposed to "do **something**." Usually, this "something" means interest rate cuts to artificially low levels ("too low" interest rates brought about by the previous boom – well-understood) and/or tax cuts, deficit spending programs, and in extreme cases outright expropriation of private property. Hardly anyone ever considers that the best policy option would be to do absolutely **nothing** and to let the excesses of the previous boom correct themselves through market forces.

The Obama administration and its economic decision makers are of course an extreme case of **"the government knows best,"** and so they implemented a combination of policies which entail some of the worst medicines the sick US economy needs right now. In particular, I am concerned about policies designed to boost the fiscal deficit (see Figure 1).

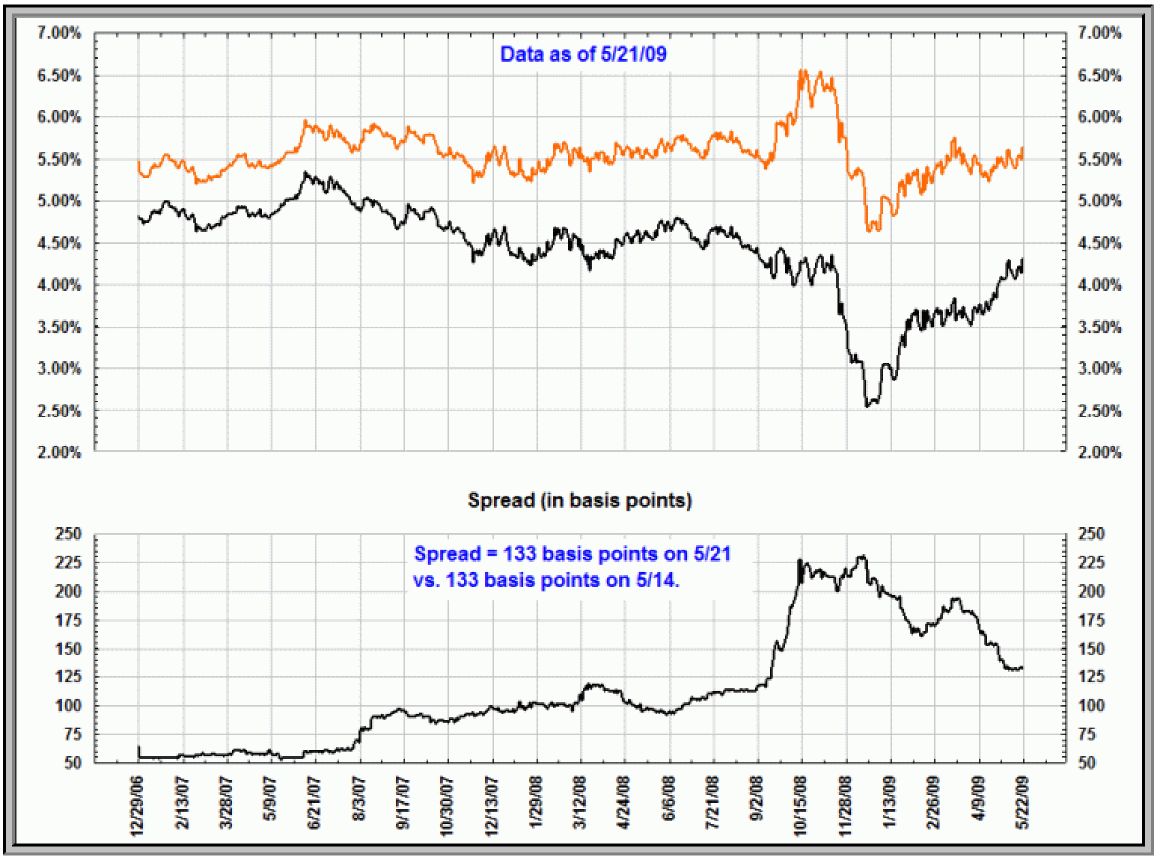
Figure 1: US Budget Deficit: Forever Up and Up!



Source: Ron Griess, www.thechartstore.com

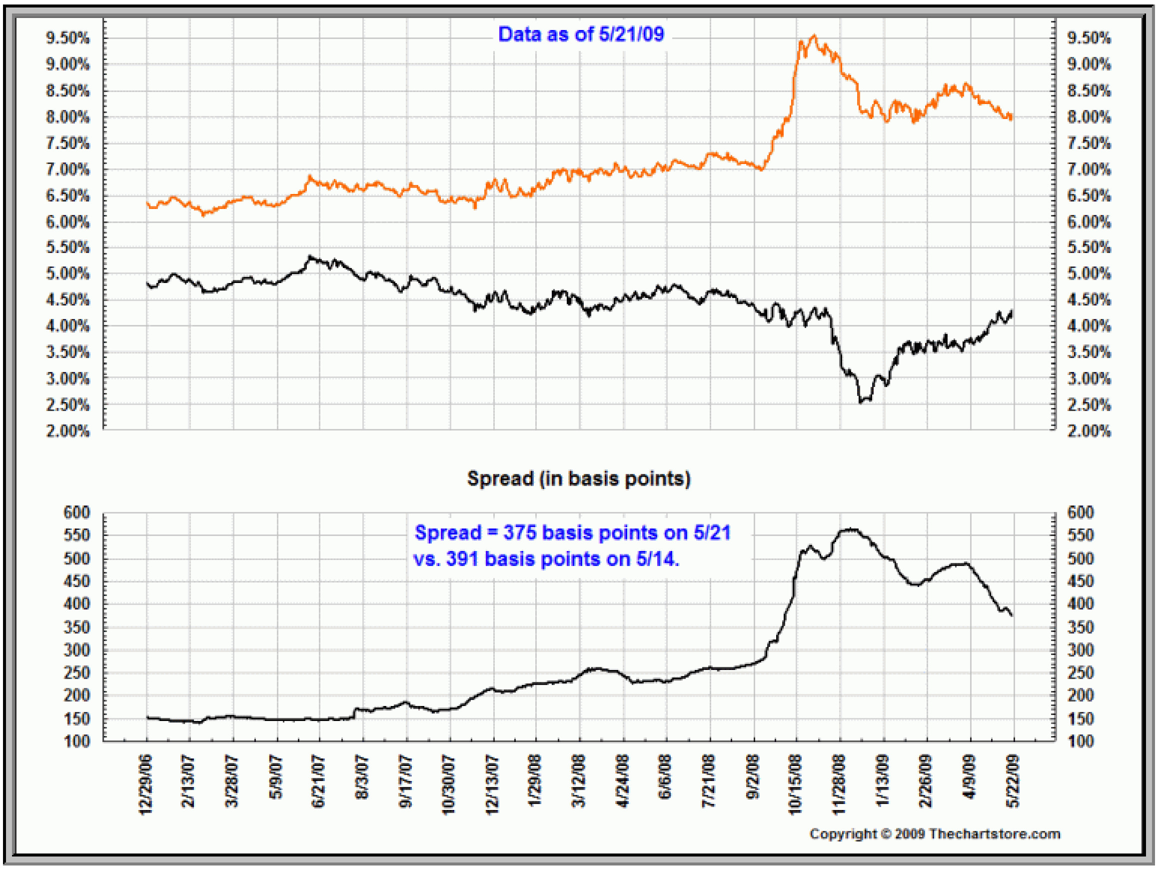
Just consider this: In January the US Commissars were still projecting a fiscal deficit for fiscal year 2009 of $1.2 trillion. Now, just three months later, the deficit forecast has been increased to $1.8 trillion. But these figures exclude future government obligations, which dwarf the official deficits. In the four years from 2004 to 2008 the unfunded liabilities of Social Security and Medicare grew by $10.4 trillion for an average annual growth of $2.5 trillion! It is, therefore, not surprising that the bond market has been reacting negatively (see Figure 2). As can be seen, the yield on the 30-Year US Treasury bond has increased since December 18, 2008 from 2.53% to over 4.5% and is just a tad lower than when the Fed embarked on its aggressive fed funds rate cuts in September 2007 from 5 1/4% to currently almost zero percent. Moreover, yields on AAA bonds are no lower than before the September 2007 rate cuts (the red line in Figure 2) while yields on Baa bonds have increased from 6.5% to over 8% (see Figure 3).

Figure 2: Yields on Moody's AAA Bonds and 30-Year US Treasuries



Source: Ron Griess, www.thechartstore.com

Figure 3: Yields on Moody's Baa and 30-Year US Treasury Bonds

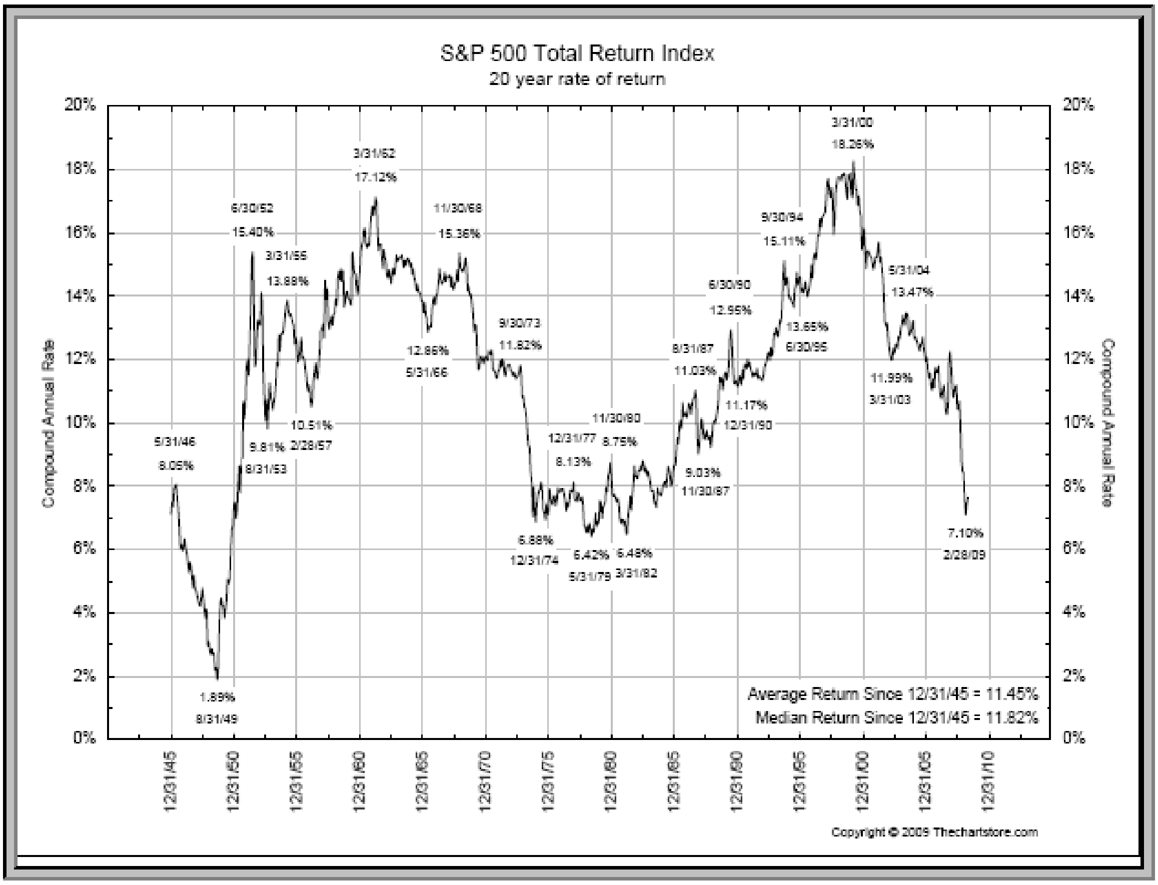


Source: Ron Griess, www.thechartstore.com

So, whereas it is true that yield spreads have come down somewhat from their highs in December 2008 (see Figures 2 and 3), which indicates an improvement in the credit markets caused by higher risk appetite among investors, the absolute yield level on all bonds is far higher than would have been the case without the huge fiscal deficit we are now faced with. I am bringing this up because should all these "green shoots" we are hearing about from the goldilocks crowd really begin to grow one would have to expect the bond market to weaken even more because the private sector's borrowing needs would compete during a recovery phase with the government's funding requirements and push up yields. Now, let us assume that US stocks return between 6% and 8% annually over the next ten years (in my opinion a relatively optimistic assumption given a) the structural problems the US economy is facing, b) the current high stock market valuations and c) less favorable demand/supply condition for equities, see below). Therefore, Baa rated corporate bonds yielding over 8% (or municipal bonds for investors in high tax brackets) could well be more attractive than equities - at least for a while (see below).

It is correct that ten years and twenty years total annual returns reached occasionally over 15% per cent per annum but we need to focus under what conditions such returns were obtained (see Figure 4).

Figure 4: S&P 500 20-Year Total Annual Return (Dividends Reinvested), 1945 - 2009

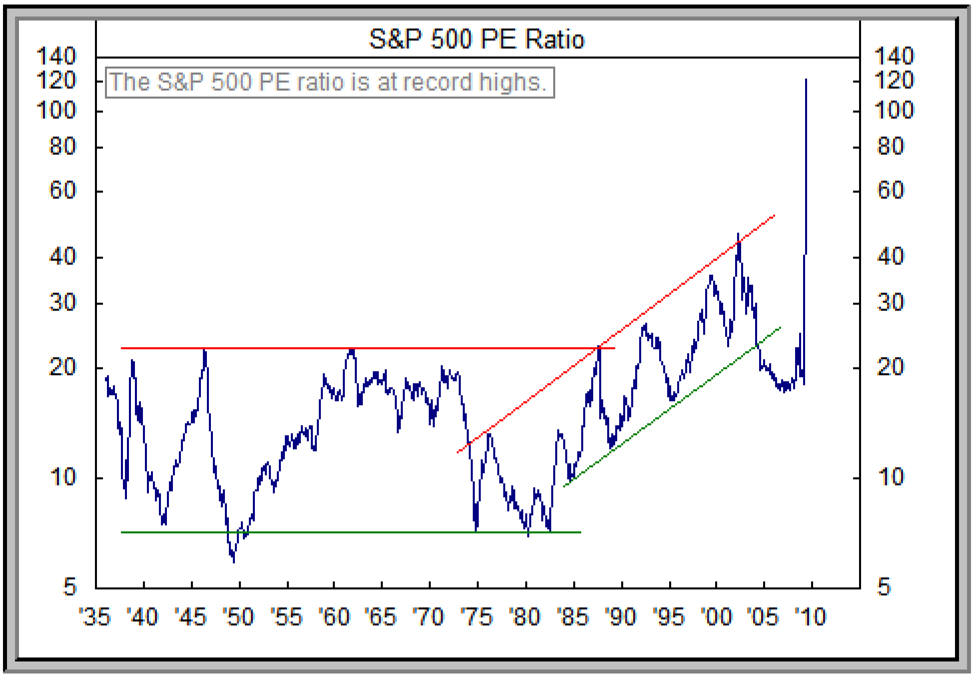


Source: Ron Griess, www.thechartstore.com

The very high 20-year return periods (1960s and 1990s) were achieved following very low stock market valuations and depressed market conditions (1940s and 1970s and early 1980s). In the 1940s, stocks were much lower than at the 1929 peak and dividend yields were three times as high as government bond yields. Also stocks sold for just 7-times earnings (see Figure 5).

Market capitalization as a percent of the economy was just around 30% and most stocks sold below book value. Similarly, in the late 1970s and early 1980s, stocks were inflation adjusted extremely depressed. At the 1982 low, US equities were no higher than in 1964, but inflation adjusted they had lost 75% from their highs. Price-to-book values and P/Es were also extremely low (see Figure 5). This is clearly not the case at present.

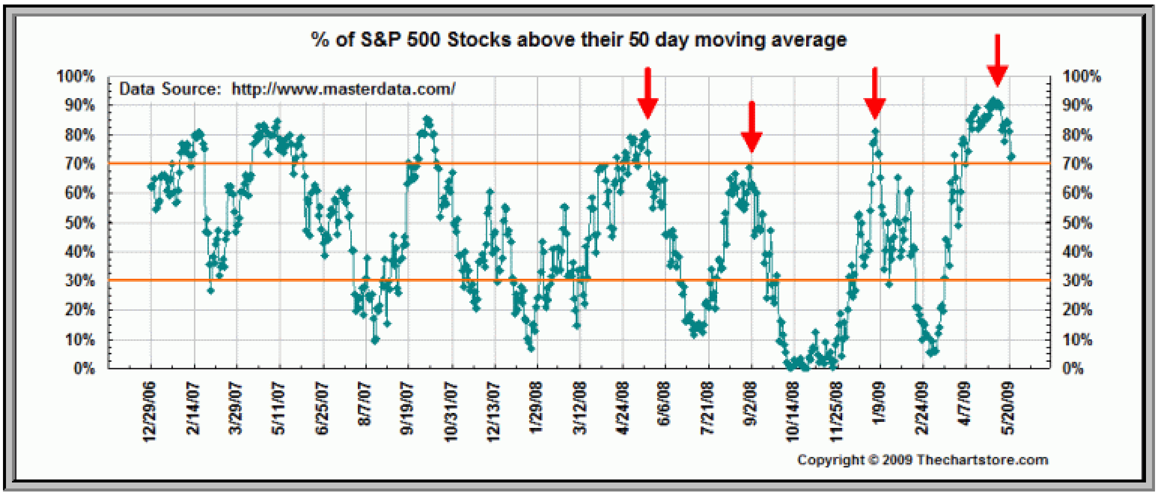
Figure 5: S&P 500 PE Ratios, 1935 – 2009



Source: www.chartoftheday.com

But let us play the devil's advocate! If S&P earnings rebound strongly in the second half of 2009 and reach in 2010 between $60 and $70 (a rather optimistic assumption in my opinion), the S&P 500 at currently 920 would still sell for 13 to 15-times earnings. This would be about the average for the last 50 years or so. On this basis I do not think that the S&P 500 is a great bargain after having rallied close to 40% from the March 6 low at 666. At the beginning of March all stocks around the world were deeply oversold and sentiment was extremely negative. But this is now no longer the case. In fact, short-term, stocks around the world would seem to be rather over-bought (see Figure 6).

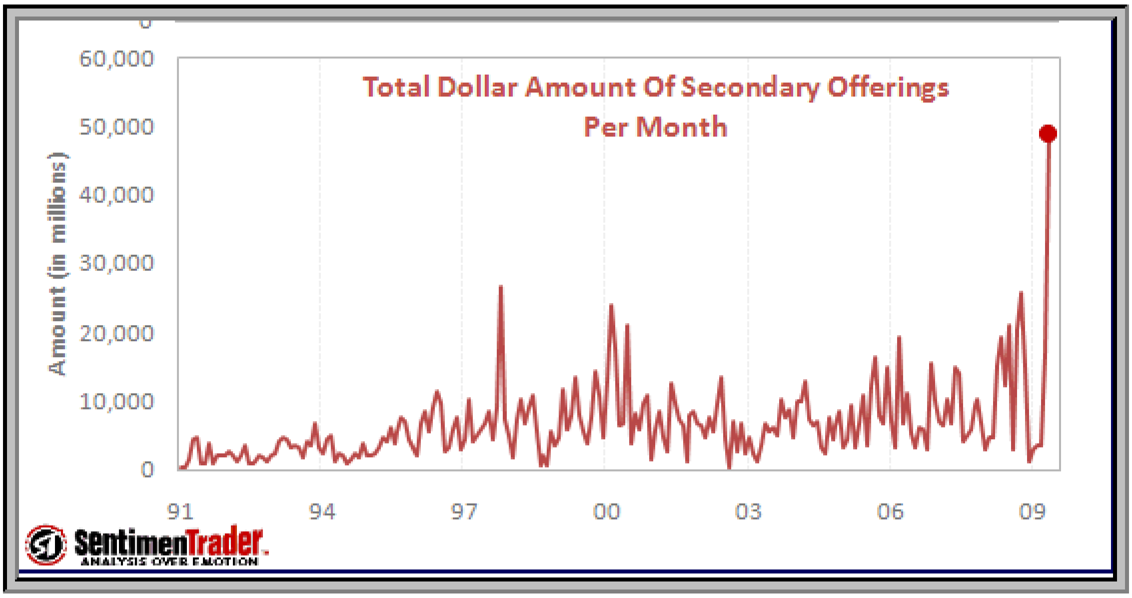
Figure 6: Percent of Stocks Above Their 50 Day Moving Average



Source: Ron Griess, www.thechartstore.com

At the same time the process of deleveraging has led to a flood of secondary offerings (see Figure 7). I should point out that whereas between 1980 and 2007 stocks enjoyed a tailwind from corporations buying back their own or other companies' shares, and from a wave of privatizations (mostly financed with debt), now the opposite is taking place. Companies are now eager to replace debt with equity, which increases the supply of shares at a time the structural demand for equities is waning (because of demographic changes).

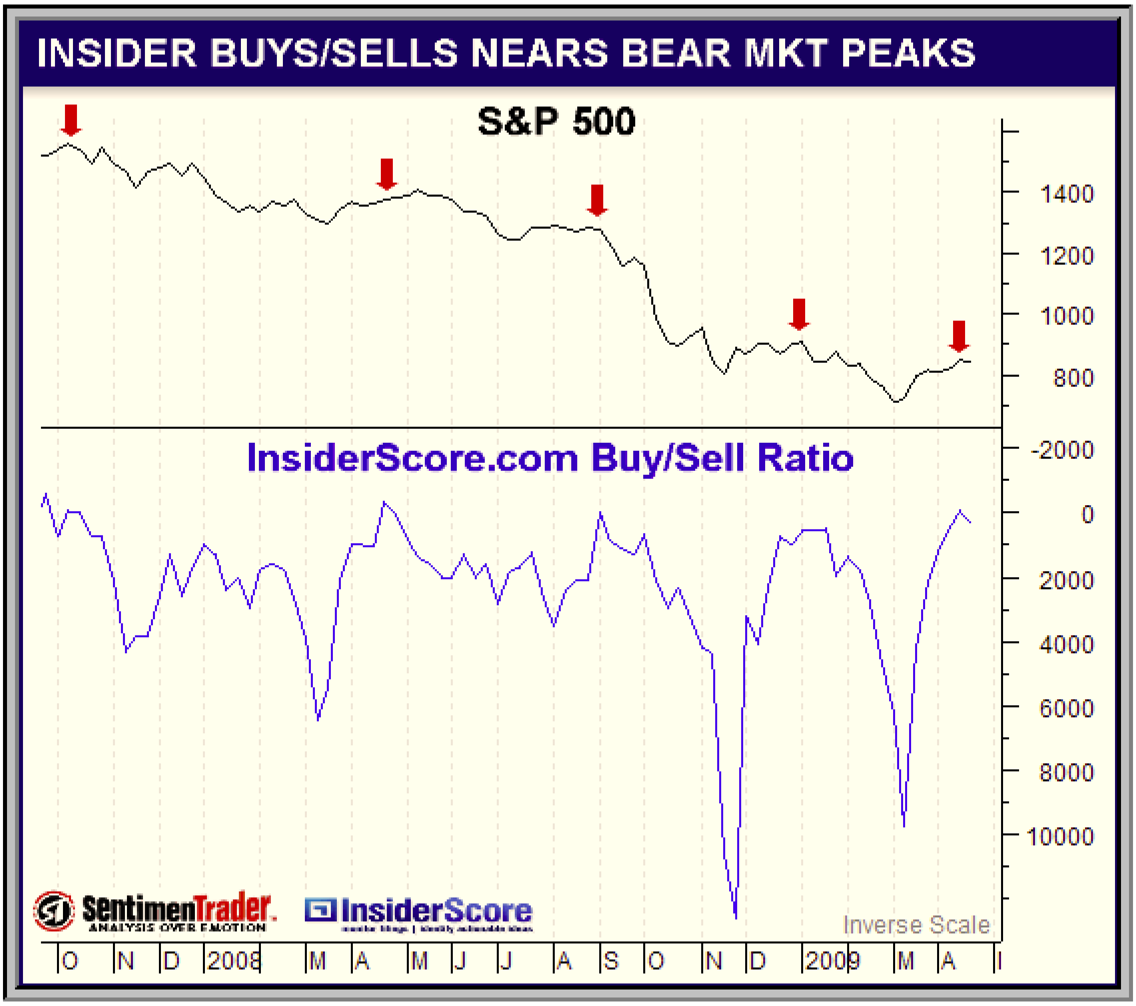
Figure 7: Increased Supply of Equities



Source: www.sentimentrader.com

Another near term warning sign is that insider sales have picked up very decisively (see Figure 8).

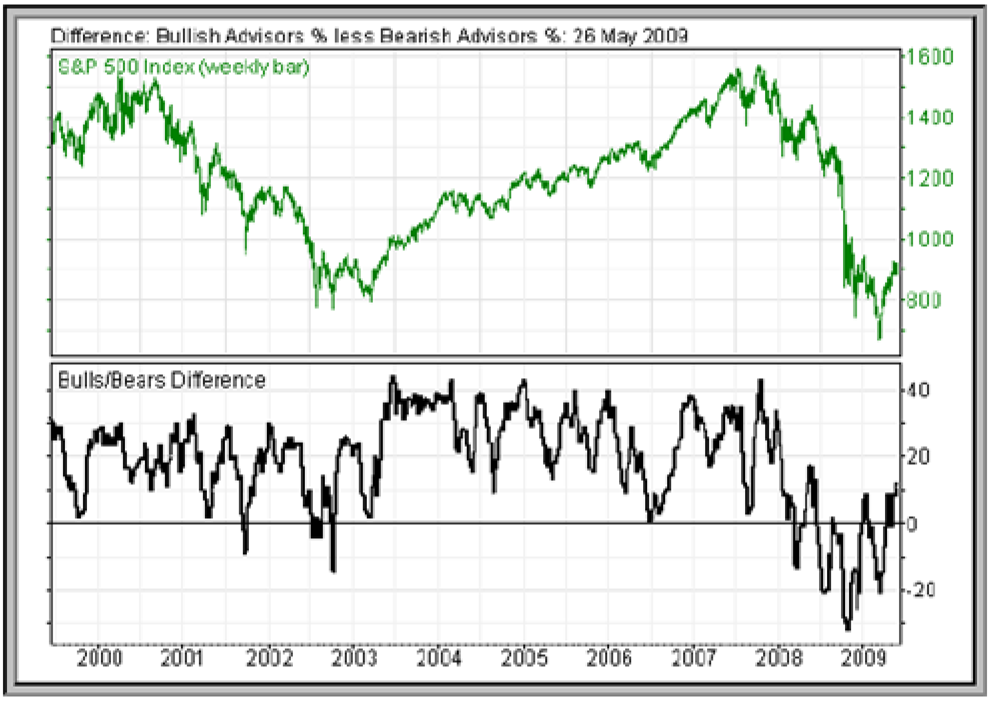
Figure 8: Insider Selling at Record Highs!



Source: www.sentimentrader.com

So, if I combine all these factors – overbought condition of stocks, heavy insider selling, an increase in the supply of equities through the conversion of debt into equity (dilution of existing shareholders), **the buying of equities right now does not seem to be particularly timely.** As explained last month, I believe that a correction should unfold in the period directly ahead, but that the market lows we reached either toward the end of last year (in most emerging markets) or in March of this year (in most developed markets) should hold. Also, the correction I expect could take the shape of a sideward movement in the major averages, or even not occur at all. After all, I can assure my readers that there are lots of big institutions out there that completely missed the powerful rally since March 6 and are now nervously waiting for the market to come down. Should markets not correct on the downside, these investors could lose their patience and their sudden rush into long positions could lead to another stock market upside explosion. In fact, the skepticism of many investors about the sustainability of this rally is reflected in the still relatively low bullish sentiment readings (see Figure 9).

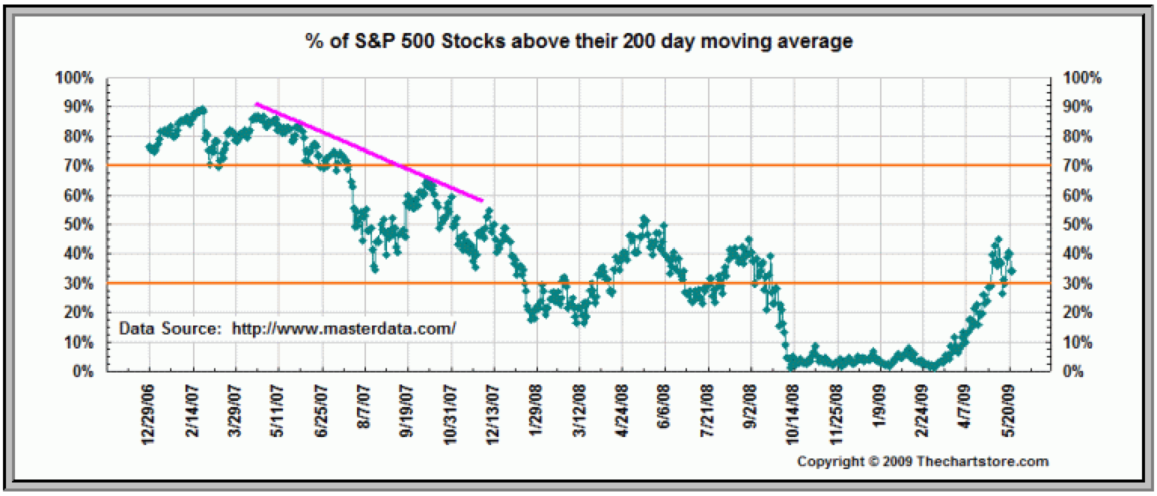
Figure 9: Bullish Sentiment Does not Suggest a Major Top yet!



Source: www.investorsintelligence.com

I expect that before the current upside move comes to an end, the “Bulls/Bear Difference” will reach close to 40! At the same time, I would expect at the next market top to see at least 70% of stocks above their 200 day moving average (see Figure 10).

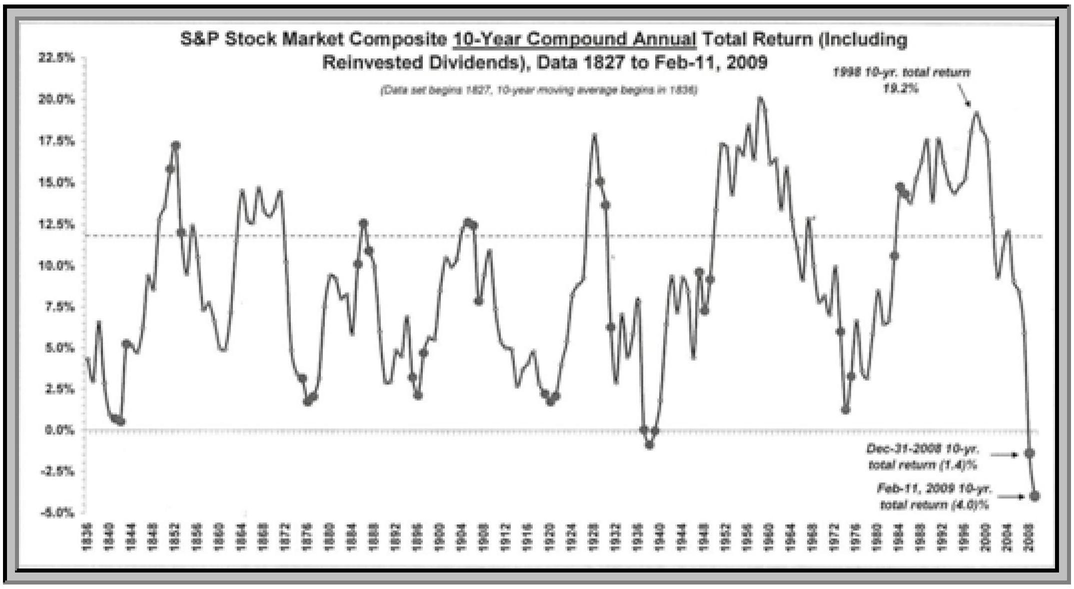
Figure 10: Percent of Stocks Above Their 200 Day Moving Average



Source: Ron Griess, www.thechartstore.com

In addition, it is likely that at the next stock market top (even if this is a bear market rally) the S&P 500 Ten Years Compound Annual Total Return, which never stays down for long, will have recovered considerably (see Figure 11).

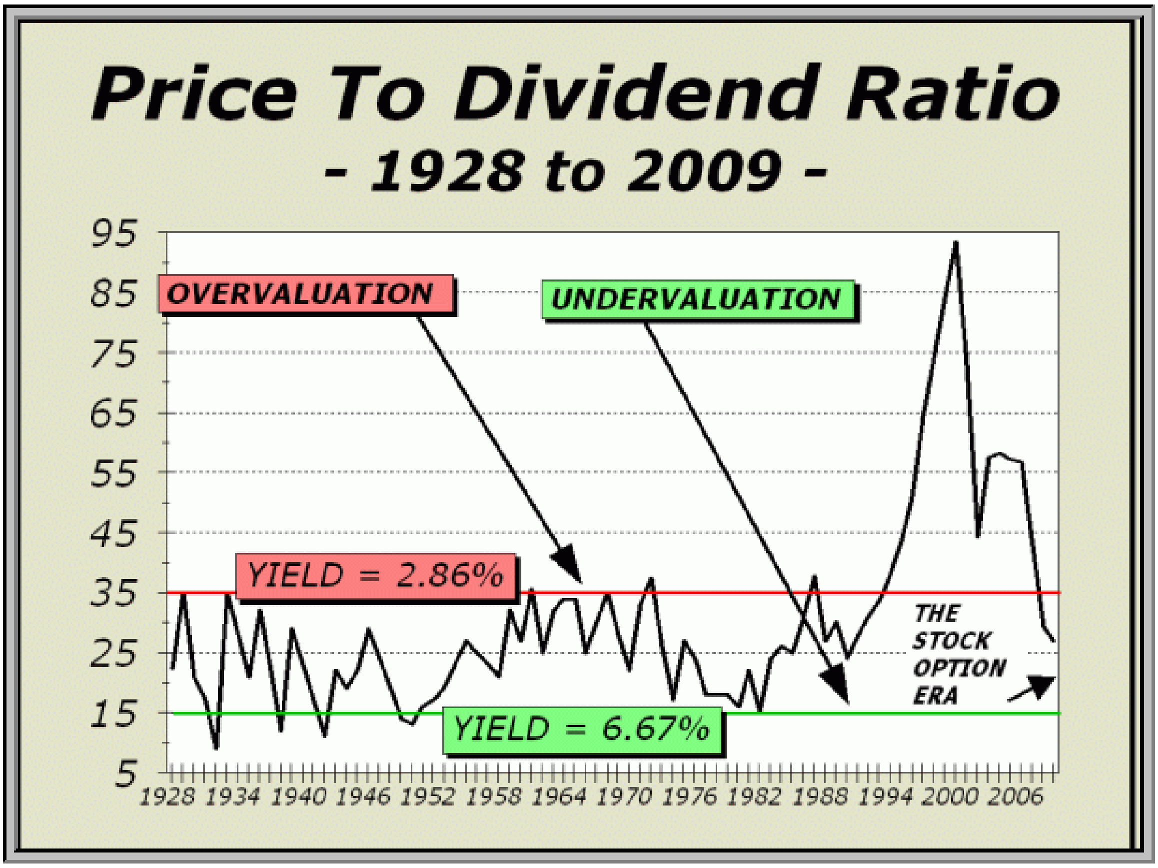
Figure 11: S&P 500 Ten Years Compound Annual Total Return, 1936 - 2009



Source: Barry Bannister, Stifel Nicklaus

Another long term positive for equities is that the price-to-dividend ratio has returned to a relatively low level, which suggests that stocks are at least in a buying range (see Figure 12).

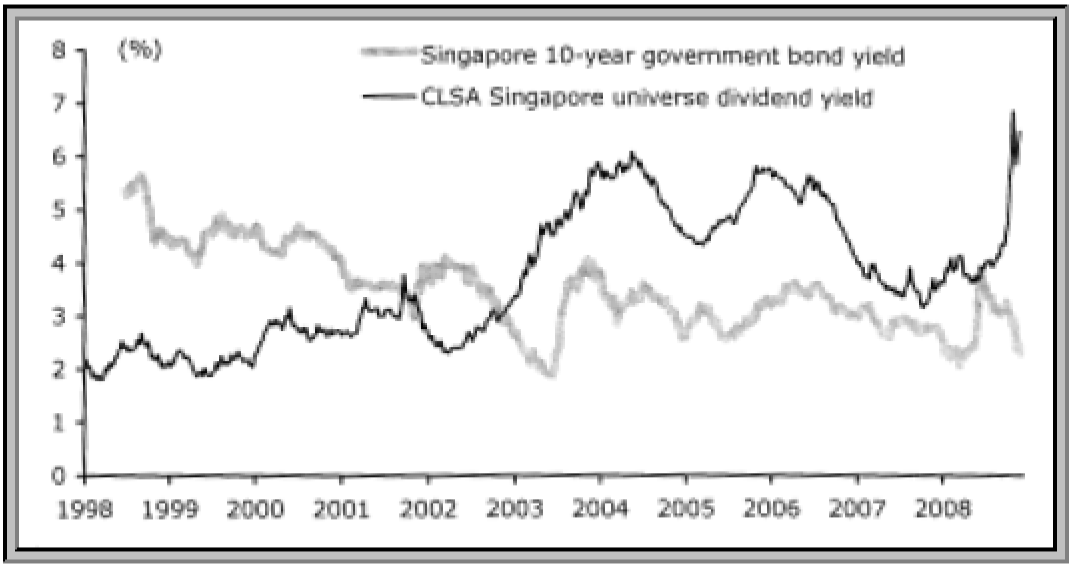
Figure 12: US Equities – Back Into a Buying Range



Source: www.cross-currents.net

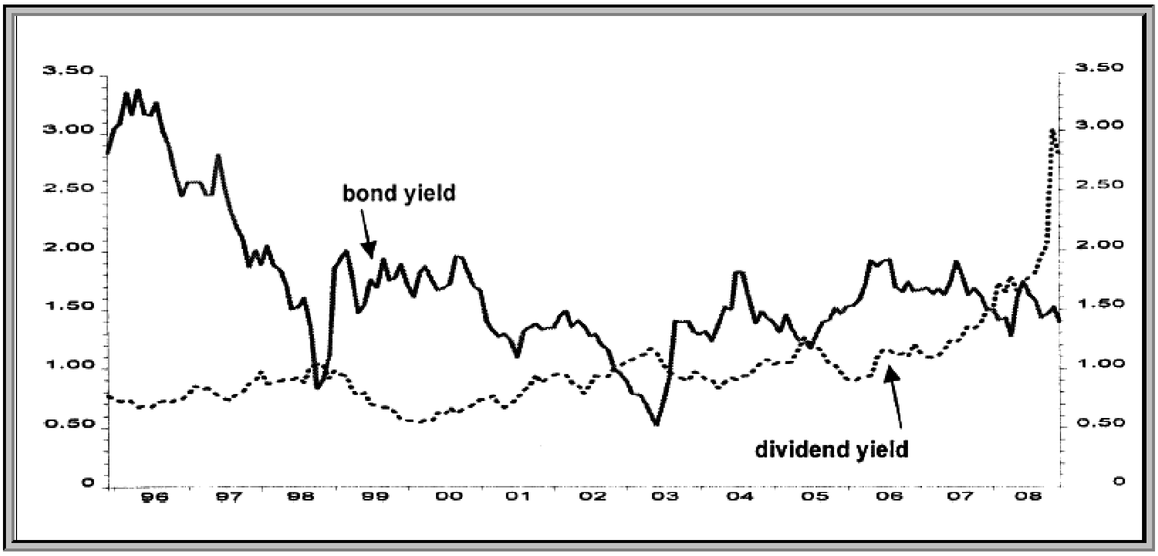
I should add that the price-to-dividend ratio is of course far lower in Asia than in the US. There are lots of companies throughout Asia which have dividend yields in excess of 5% (or have large free cash flows which enable them to buy back their shares). Also, as can be seen from Figures 13 and 14, stocks in Asia have far higher dividend yields than the domestic bond yield.

Figure 13: CLSA Singapore Universe Dividend Yield and Ten-Year Government Bond Yield, 1998 - 2008



Source: Chris Wood, CLSA

Figure 14: Japan Bond Yield and Dividend Yield



Source: Albert Edwards, Societe General

In a recent discussion a large institutional investor exclaimed, “I just can’t believe it, here we have the super bear Marc Faber being so optimistic about stocks!” I responded, “it is precisely because I am so super negative about the world that I prefer to invest in equities and in commodities rather than in cash and in US government bonds." (See Figure 15.)

In last month's report I discussed the abstruse views of Professor Mankiw. Unfortunately, these views are shared by most US economists including Kenneth Rogoff, former chief economist at the International Monetary Fund, who recently said, "I'm advocating 6 percent inflation for at least a couple of years. It would ameliorate the debt bomb and help us work through the deleveraging process." Great! So the US should have 6% inflation for a couple of years (how many years precisely?) at a time when short term interest rates are close to zero and 10-year Treasury notes yield less than 3.5%!

Figure 15: US Economic Policies: Great for Commodities!

Source: www.decisionpoint.com

I have met Ken Rogoff before and I actually have a very high opinion of him (for sure a far higher opinion than of Professor Krugman, whose recent criticism of the Austrian School of Economics shows that he really has no clue about economics – an impression I had already following a discussion with him in the late 1990s when he claimed the NASDAQ would never decline). But this is the point: When economists - who under "normal conditions" are very level-headed - advocate the expropriation of savers (cash holders) to the tune of 6% per annum (through inflation), you have to wonder what the Obama administration and its policy makers will come up with next. In such an environment you just don't want to be in cash US dollars and US government bonds, but in equities, selected commodities, and commodity-related shares (see Figure 15 and 16).

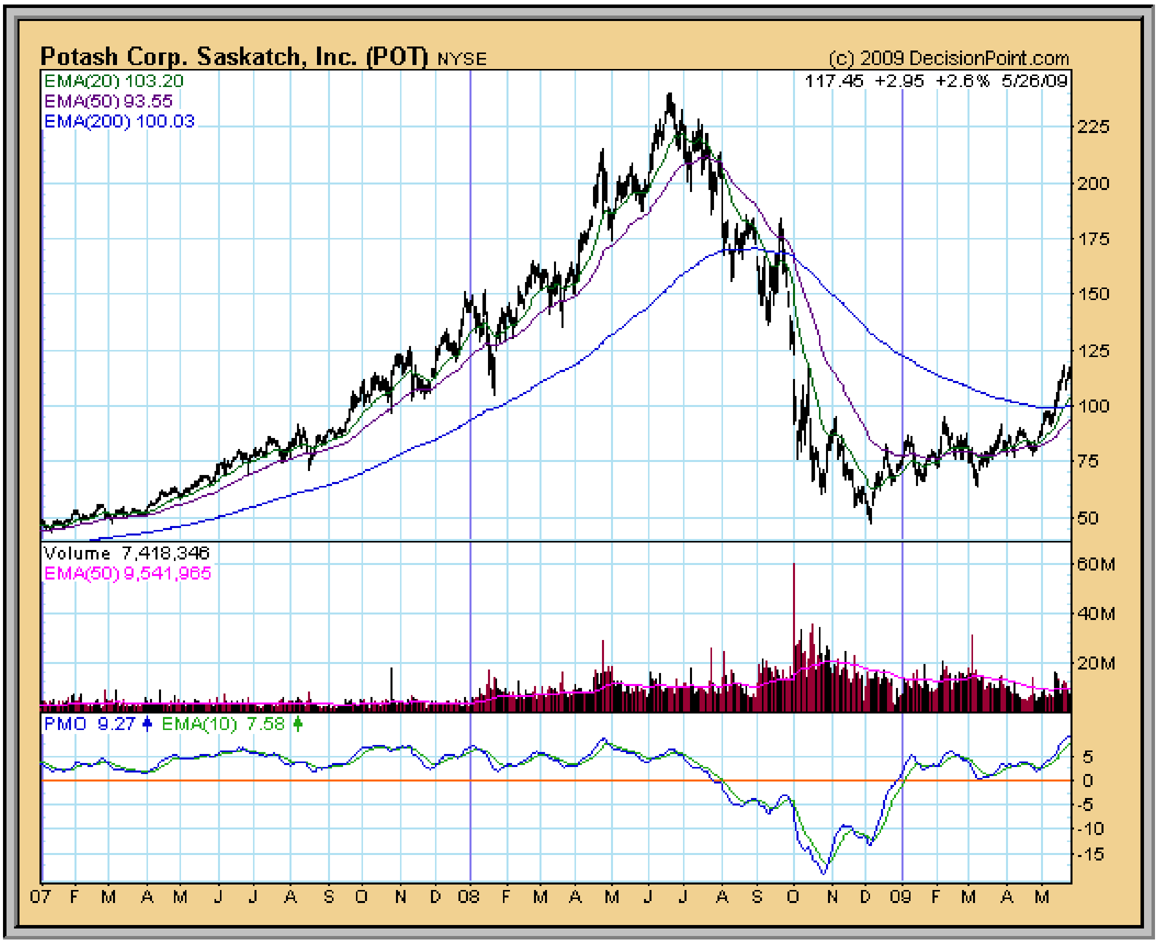
Figure 16: A Pure Play on Agricultural Commodities

Source: www.decisionpoint.com

Just as an aside: inflation is a dynamic process and it is not possible to fix it at 6%. If inflation increases from the current level of, say, 2% per annum to 6%, it will likely thereafter accelerate to far higher levels, largely thanks to Mr. Geithner's and Mr. Bernanke's Bernanke's economic policies of combining huge fiscal deficits, which are unlikely to come down in the next few years, with easy money!

Numerous investors recently asked me about investments in agricultural commodities. The best for the astute investor is to play them through trading in the futures markets. Then an investor could buy companies which own agricultural land, plantations and forests such as Cresud (CRESY – see Figure 16) and fertilizer companies (see Figure 17).

Figure 17: Potash Corp (POT), 2007 - 2009

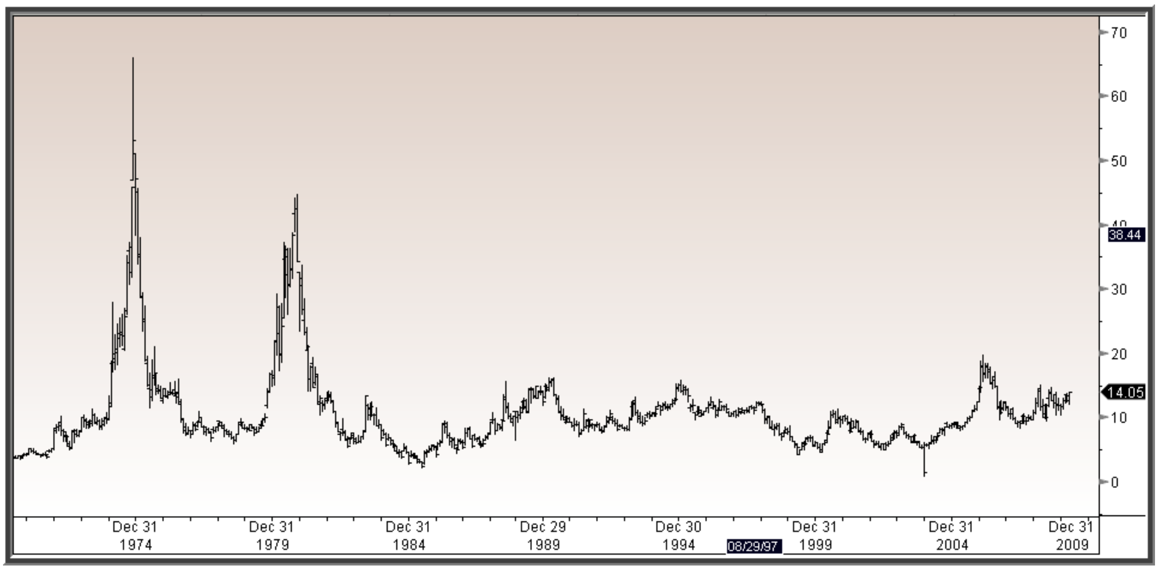


Source: www.decisionpoint.com

(For what it's worth, Robert Friedland just became chairman of Potash One in Canada - KCL CN.)

As I indicted in earlier reports, the fundamentals of sugar have greatly improved and I would not be surprised to see a move toward 25 cents per pound (see Figure 18)

Figure 18: Sugar Prices, 1972 - 2009



Source: Bloomberg

So, what should investors do? I would take some money off the table right now (I partly hedged my long Asian stock positions through short positions in S&P futures). How deep the correction will be we do not know, but following a 39% rise, the S&P could easily drop back 10% to 20% (or even more). It is also possible that the stock markets continue to move up right away. But obviously the risk today is higher than it was earlier this year when we were pounding on the table to buy equities. I am neither young enough nor Paul Krugman to know everything (Paul Krugman: "….'Austrian theory' of the business cycle—a theory that I regard as being about as worthy of serious study as the phlogiston theory of fire"). I maintain long positions in gold, mining related companies, and some corporate bonds.

Lately, US government bonds have tumbled and the US dollar has been weak. Both are near-term oversold and should shortly rebound (sell TBT).

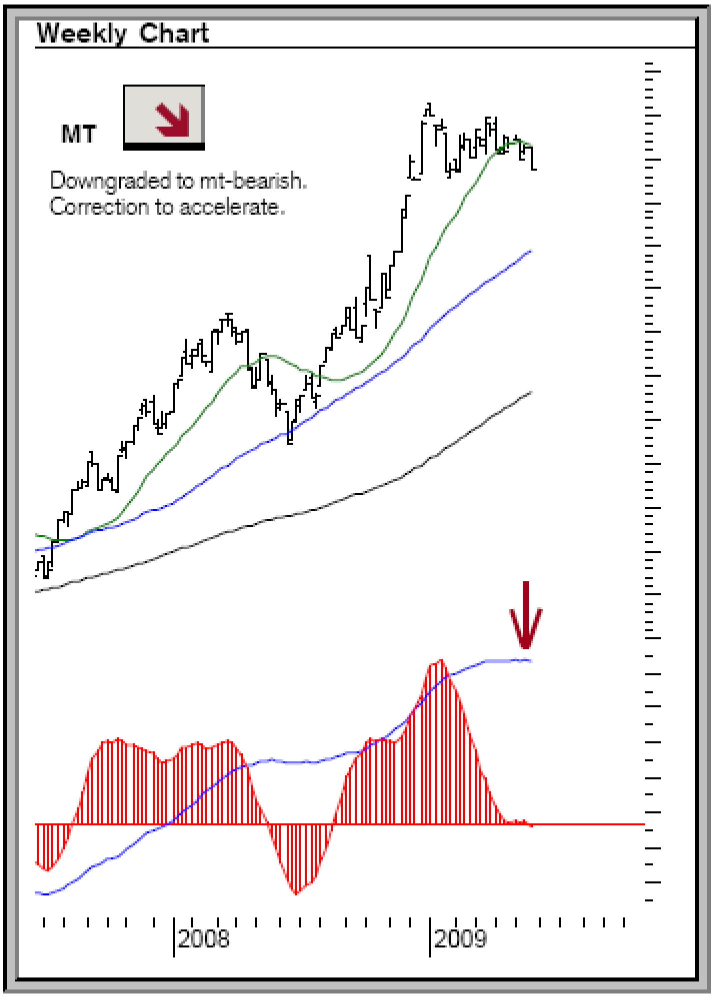
On a US dollar rebound I would shift more funds into Canadian dollars and into Asian currencies.

I believe that a US dollar and US government bond market rebound is likely to coincide with a stock market correction (as liquidity would tighten).

As always, the accumulation of precious metals is recommended. Longer term investors should be out of US government bonds and look for investments in commodities, commodity-related companies, and hard assets.

It is noteworthy that the JP Morgan Global Bond Total Return Index is a mirror image of the CTB Index (see Figures 15 and 19).

Figure 19: JPM Global Bond Index Total Return



Source: www.credit-suisse.com/research

"There is no nonsense so errant that it cannot be made the creed of the vast majority by adequate governmental action"

Bertrand Russell