Unnatural Market Moves, that too Is Natural!

Marc Faber

> **Political correctness is really a subjective list put together by the few to rule the many -- a list of things one must think, say, or do. It affronts the right of the individual to establish his or her own beliefs.**
>
> **Mark Berley**

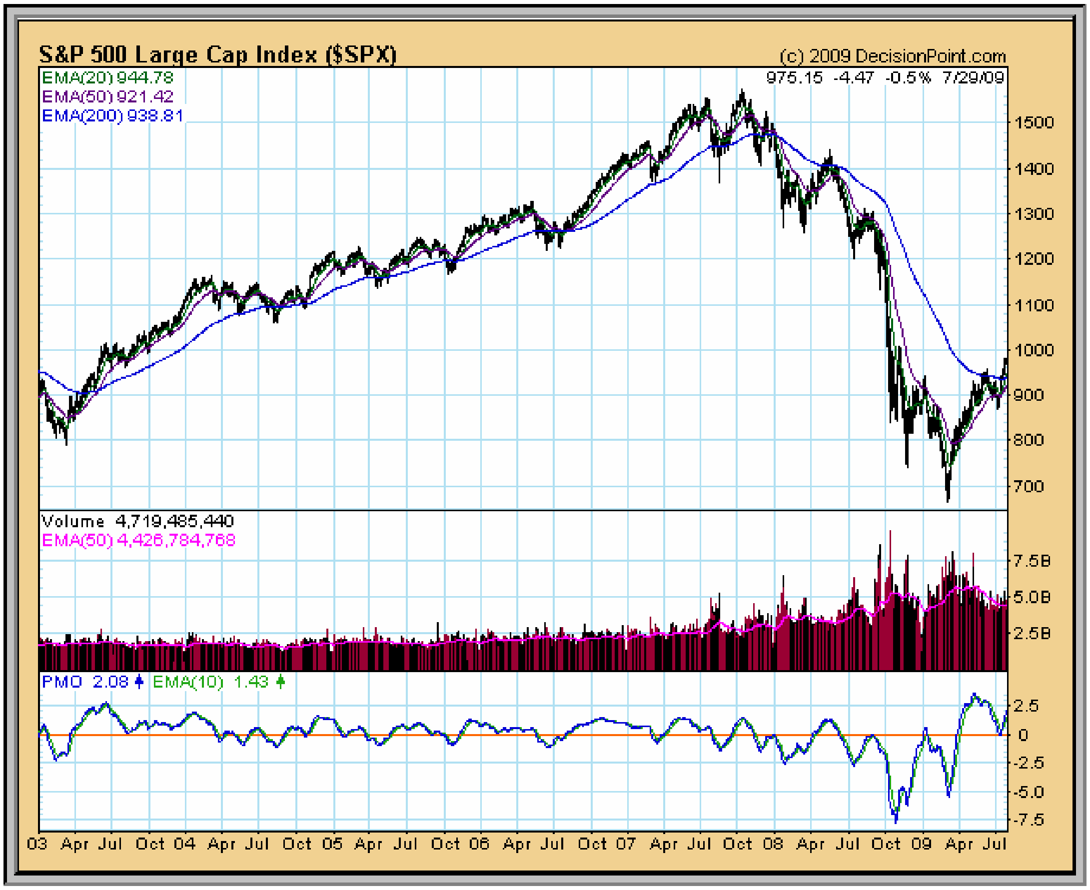
> **A people living under the perpetual menace of war and invasion is very easy to govern. It demands no social reforms. It does not haggle over expenditures for armaments and military equipment. It pays without discussion, it ruins itself, and that is an excellent thing for the syndicates of financiers and manufacturers for whom patriotic terrors are an abundant source of gain.**
>
> **Anatole France**

> **Democracy must be something more than two wolves and a sheep voting on what to have for dinner.**
>
> **James Bovard**

According to Bloomberg, Wall Street firms just raised their 2010 earnings estimate for the S&P 500 from $72.54 a share in May to $74.55. For 2009, analysts see earnings in the vicinity of $59.80. Based on this new forecast, the S&P 500 currently trades at 13.13 times estimated profit, well below its 50-year average of 16.54. Since the S&P 500 index trades currently at around 970, it would need to rise to 1,233.06 for the multiple to equal its historic average since 1959.

While I can see that the S&P 500 could rise to around 1250 within the next 12 months or so, I doubt it would happen because S&P earnings will increase to $75 (see Figure 1)

Figure 1: S&P 500 Index, 2003 - 2009



Source: www.decisionpoint.com

In fact, I tend to agree with David Rosenberg who says that "much is being made of the fact that over 70% of U.S. companies are beating their low-balled earnings estimates, but the majority are still missing their revenue targets (as per Verizon and Honeywell in yesterday's reports — top-lines down 6.7% and 22% respectively). Even so, a momentum-driven market will always be driven by just that — momentum; and there's no doubt that investor risk appetite is being whetted. But after paying for the end of the recession in May, the market is now pricing in 40-50% earnings growth for next year, and while costs have aggressively been taken out of the system, this sort of unprecedented profits revival can only occur in the context of a V-shaped recovery, which we give 1-in-50 odds of occurring."

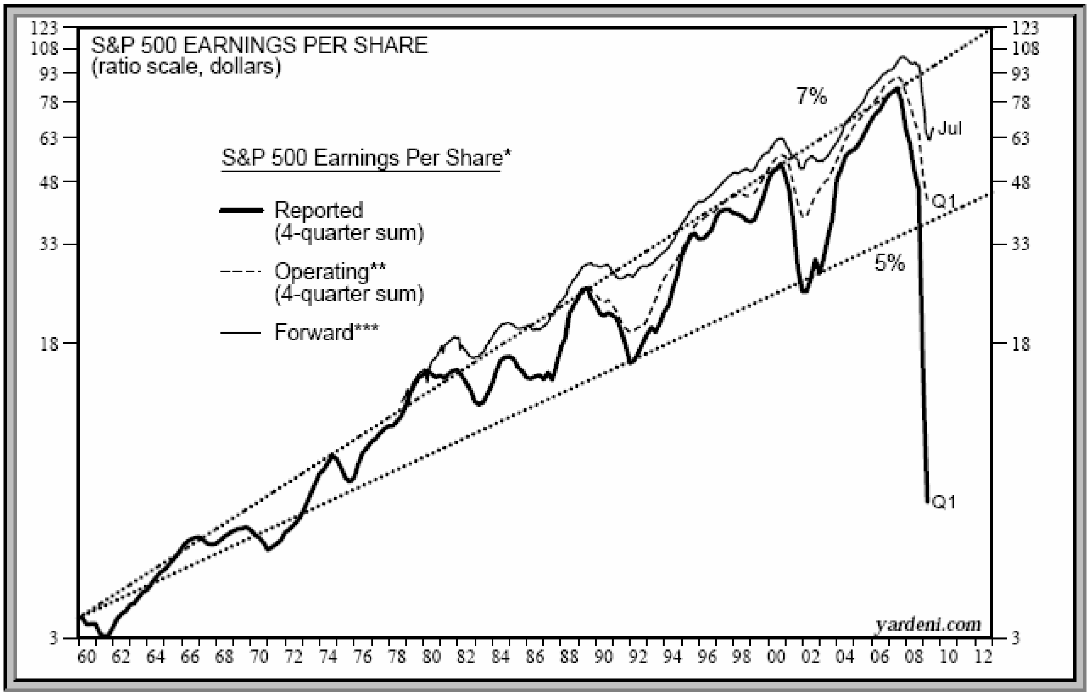
Take as an example Caterpillar (CAT – see Figure 2)). The company reported second quarter earnings of $0.72 per share compared to $1.74 a year ago (street estimates were just $0.22 – it shows the reliability of analysts estimates….) but sales were down by 41% year-on-year (street estimates called for revenues to be down 35%).

Figure 2: Caterpillar, 2005 – 2009

Source: www.decisionpoint.com

I have the following problem with the $75 estimate for S&P earnings in 2010. S&P earnings peaked out on an annualized basis in late 2006 at around $ 85 (see Figure 3). But these peak earnings occurred in the context of an unprecedented synchronized global economic boom when financial sector earnings (including financial subsidiaries of industrial companies such as GE Capital) accounted for over 40% of S&P earnings! Now, I leave it to the fantasy of our readers (and a lot of fantasy is required) to consider how probable 2010 S&P 500 earnings per share estimates of $75 are when in the best of all times S&P earnings peaked out at $85 (see Figure 3).

Figure 3: S&P 500 Earnings per Share, 1960 - 2009

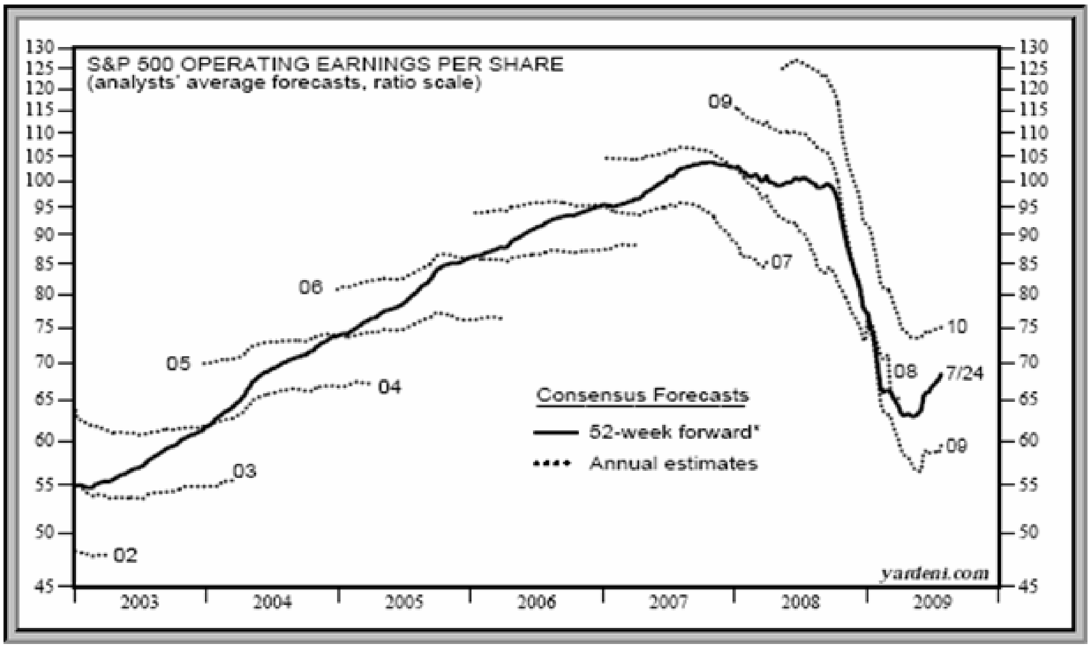


Source: Ed Yardeni, www.yardeni.com

S&P 500 EPS of $75 in 2010 would imply a very strong recovery in financial sector earnings, oil prices, which affect energy companies' earnings, of well above $100, and revenues for companies such as Caterpillar to rebound by at least 30% next year. In my opinion, these are all not very likely occurrences! I should add that if analysts' forecasts of 2009 earnings of $59.80 are correct, S&P earnings would bottom out at about twice the level of 2003 when economic conditions are far worse today than they were in 2003 (see Figure 3). In addition, a recovery to $75 in 2010 would bring S&P 500 EPS to above the trend-line, as a well informed friend of ours noted. I would once again warn our readers not to pay too much attention to analysts' forecasts. Earnings forecasts decline as the stock market falls and increase as the stock market goes up (see

Figure 4). Incidentally, as can be seen from Figure 4, analysts were still forecasting S&P earnings of $110 as late as in the summer of 2008!

Figure 4: S&P 500 Consensus EPS Estimates, 2003 - 2009



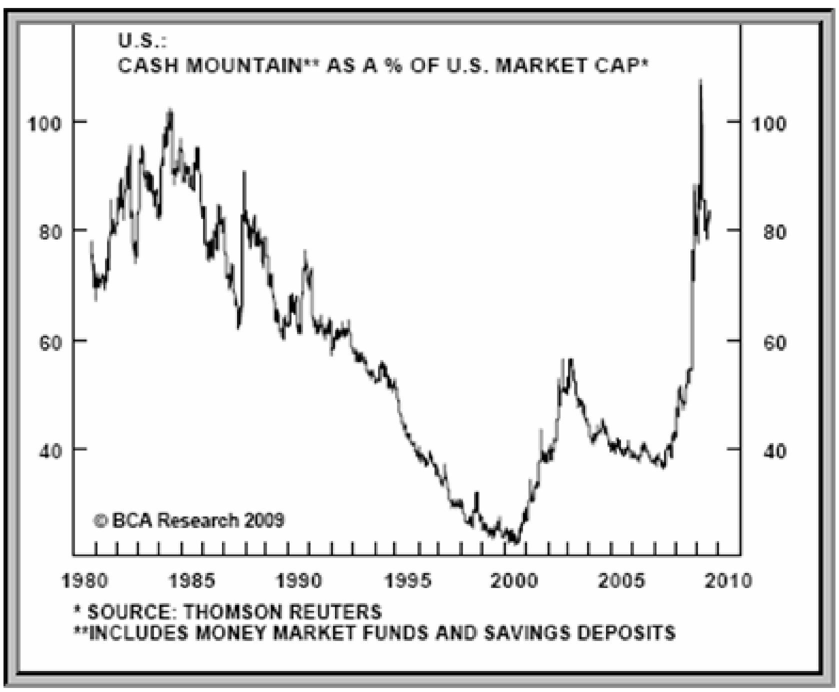
Source: Ed Yardeni, www.yardeni.com

In an article for Bloomberg, David Pauly takes analysts to task for continuing to keep telling the "big earnings lie." According to him, "at a time when the financial industry's credibility is at an all-time low, you would think Wall Street's finest would break their necks providing transparency. Not so. Stock analysts continue to promote corporate earnings lies, insisting that net income isn't really what investors need to know. Instead, their earnings estimates ignore often huge expenditures that can't help but affect a company's health." He cites a few examples of instances where analysts simply discarded material charges: "Time Warner Inc., a rival of Viacom for entertainment dollars, said it earned $519 million, or 43 cents a share, in the quarter. Analysts insist Time Warner earned 45 cents, excluding, according to Bloomberg data, costs related to litigation and asset sales. Lawyers must work for nothing. By similar Wall Street reckoning, the expense of cutting jobs and selling an asset that reduced McGraw-Hill Cos. second quarter earnings per share by 10 percent was immaterial. Analysts also say investors should ignore $129 million that Textron Inc., maker of small airplanes, helicopters and golf carts, charged against net income in the latest quarter. Included was the cost of shutting a plant for an eight-seat jet Textron decided not to build." Pauly concludes that "Wall Street's big earnings lies must exasperate investors. They already have lost faith in the reported earnings of banks that are the center of the financial system. Exactly how impaired are banks' impaired loans? The Financial Accounting Standards Board, under political pressure, has ruled that the banks decide. Might as well ask a six-year-old who took the cookies."

I fully agree with David Pauly and in fact believe that one of the most negative factors for the longer term is that whereas a serious financial crisis is supposed to clean the system, the current crisis has actually increased dubious financial practices and reduced financial and economic transparency. Therefore, the ultimate financial crisis still lies ahead of us!

Still, we have to also accept some positive factors such as very substantial cash holdings (see Figure 5).

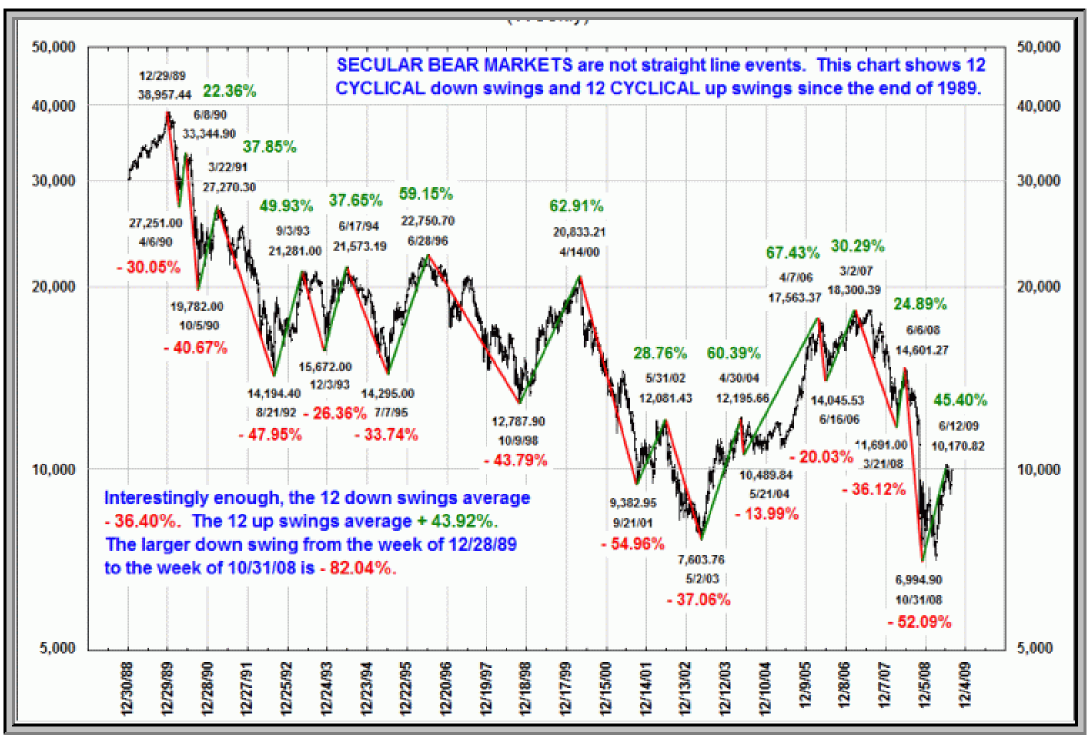
Figure 5: Cash as Percentage of US Stock Market Capitalization



Source: The Bank Credit Analyst

But not only are cash holdings very large, they also hardly provide any return since the Fed's policy has been to cut interest rates to almost zero percent. As a result, savers are being punished and in fact encouraged to speculate in the one or the other asset class. Now, put yourself in the shoes of a fund manager or individual investor, who missed to participate in the March 6 to June 10 rally and subsequently expected a 10% to 20% correction (as I did), which never really materialized (the S&P dropped only 9% between June 10 and July 11). Therefore, these investors are likely to also have missed the subsequent rally, which took the S&P 500 from 879 on July 11 to above 985 (the Dow Theory only provided a "buy signal" ten days ago – after a more than 40% rally from the March lows). So, I can only imagine that these fund managers and investors must feel fairly nervous and very fearful that the rally could extend further on the upside. Don't misunderstand me. I am ultra negative about the long term economic and political outlook and, as I indicated above, I think that this crisis has completely failed to "clean" the system. But within worsening conditions markets can still have very meaningful rallies (see Figure 6).

Figure 6: Nikkei Index, 1988 - 2009

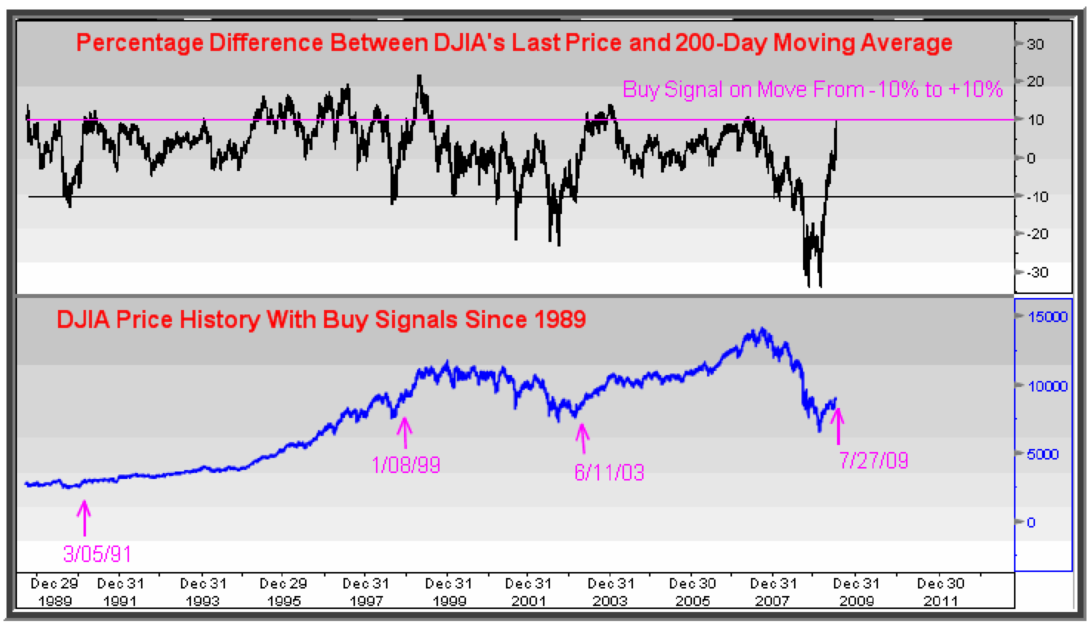


Source: Ron Griess, www.thechartstore.com

As can be seen from Figure 6, between 1989 and 2009 the Nikkei Index had six rallies of 45% or more, which - within a down-trend - led to the final low in March of this year (so far) - almost 20 years after the late

1989 peak. But, as Walter Bagehot (the 19th century British businessman, essayist, and editor of the Economist) wrote, "John Bull can stand many things but he cannot stand 2%." With interest rates not at 2% but at zero percent, the pressure on investors to put money to work somewhere is therefore huge and leads to the volatility which was endemic to the Nikkei Index over the last twenty years (see Figure 6). Fund managers and investors are usually not prepared “to fail in originality than succeed in imitation” (Herman Melville), “when they are free to do as they please they usually imitate each other” (Eric Hoffer). So when some technical indicators, such as the Dow Theory and the Dow Jones Industrial Average, which has rebounded from at least 10% below the 200-day level to 10% above, give strong buy signals, fund managers tend to become momentum players, give up their bearish stance, and get sucked into the market (see Figure 7).

Figure 7: Percentage Difference between the Dow Jones and Its 200-Day Moving Average, 1989 - 2009



Source: Bloomberg

However, a word of caution! It is true that, as Bloomberg data shows, “eighteen of the last 21 times the Dow rallied from at least 10 percent below the 200-day level to 10 percent above, it posted an average advance of 18% during the 12-month period following buy signals since 1921” (in the following three months, it climbed 18 times, averaging an increase of 5.7%). But in markets that moved largely sideward, as was the case between 1929 and the early 1950s and in the seventies, most of these gains were subsequently given back. Moreover, if we look at the volatile performance of the Nikkei within a 20-years downtrend the so called 10% down/up 200- day moving average rule provided countless false signals! Investors who bought the Nikkei Index following buy signals under this rule should have remembered Mark Twain, who said, “I was seldom able to see an opportunity until it had ceased to be one." Still, we need to respect the powerful stock market action and the number of stocks which gapped up (see Figure 8).

Figure 8: Breakaway Gaps from Bottom Formations are Positive!

Source: www.decisionpoint.com

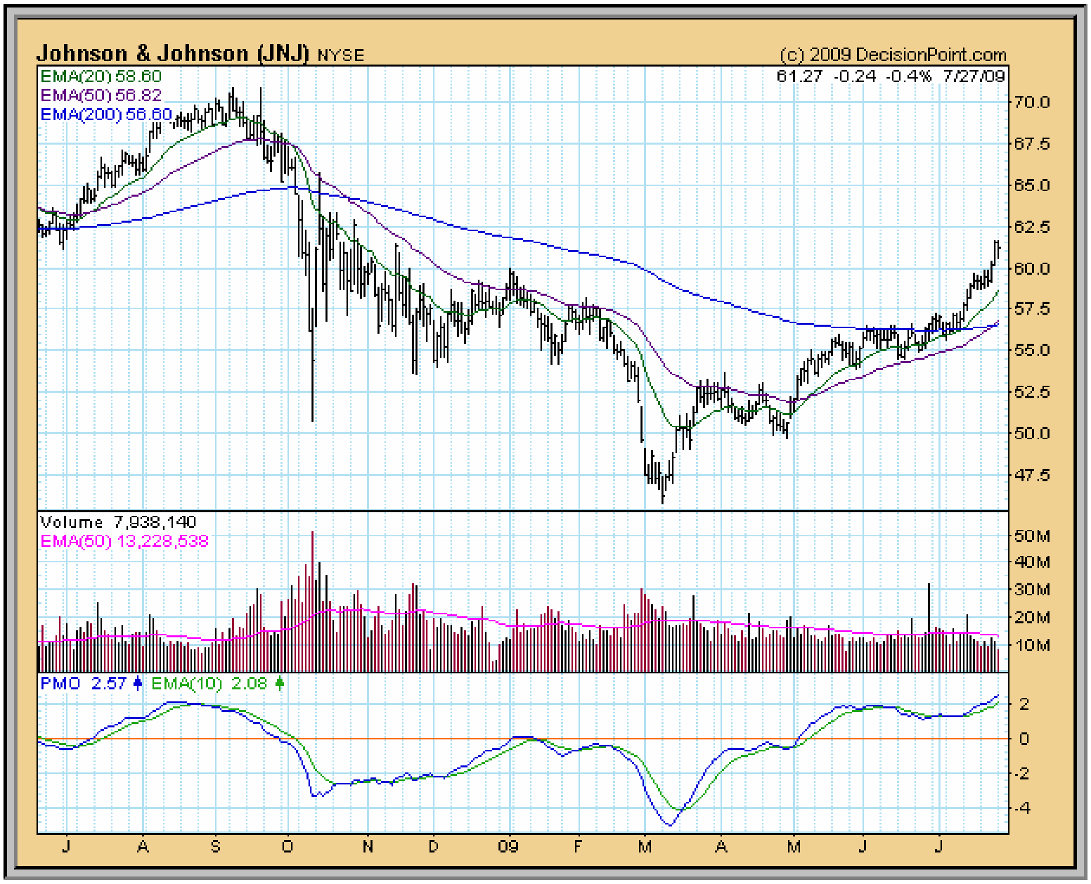
According to the “Momentum Gap Method,” when stocks gap up with high volume from a well established bottom formation and the gap does not close within a few days, the implications are extremely bullish. As can be seen from Figure 8, neither was the up-side gap of Merck nor the one of Intel closed (see Figure 9).

Figure 9: Intel – High Volume Upside Gap!

Source: www.decisionpoint.com

Aside from those stocks that have already gapped up (Cisco, International Paper, Dow Chemical, Ford, Caterpillar, etc.), what is encouraging is that the number of such upward gaps is widening into many different sectors of the stock market. In other words, it would seem that despite the near term overbought condition of the stock market the advance is broadening! In addition, a very large number of stocks have broken out on the upside from well-established bottom formations (see Figure 10) or are about to break out on the upside (see Figure 11).

Figure 10: Johnson & Johnson, 2008 - 2009

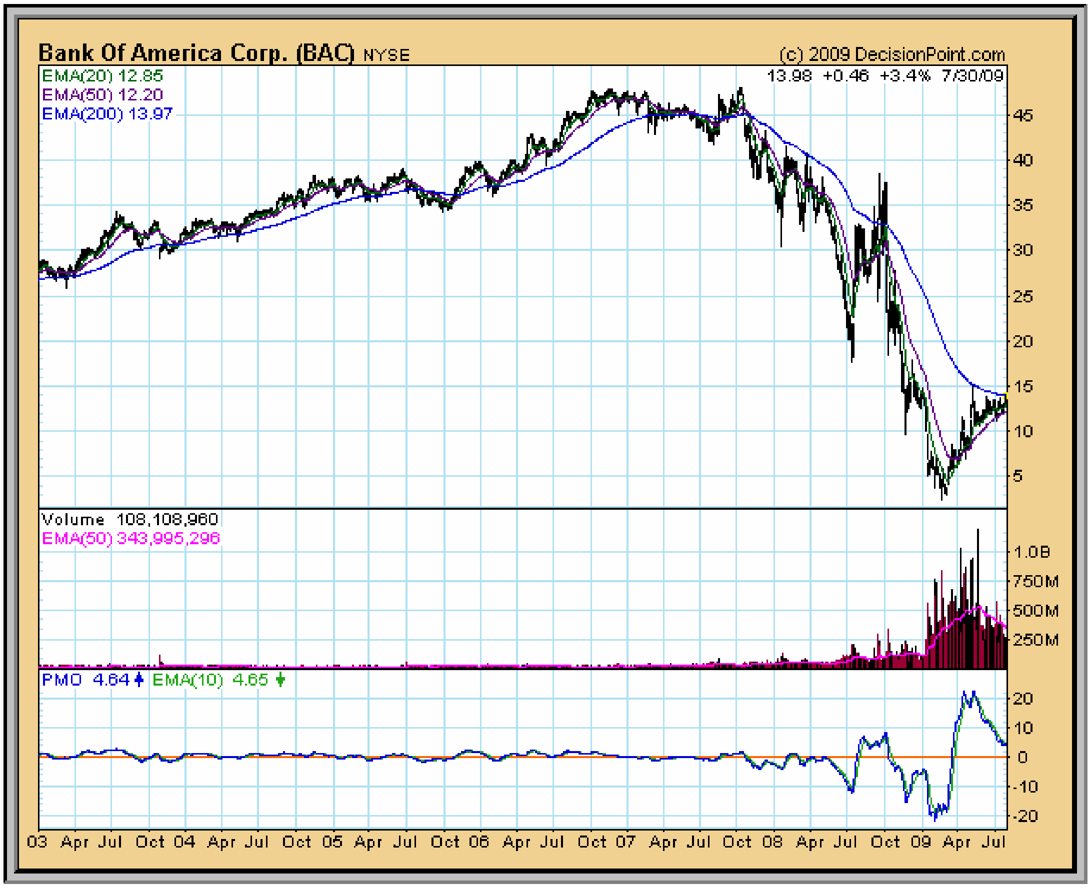


Source: www.decisionpoint.com

I should add that we observe similar favorable chart formations for equities all over the world and in particular in Asia. Under "normal conditions" these positive stock market conditions would signal a strong global economic recovery. But my view is quite different.

I think equities are rallying because economic conditions will continue to deteriorate and necessitate additional stimulus packages and further quantitative easing (read money printing).

Figure 11: Financial Stocks Worldwide Have further Upside Potential!



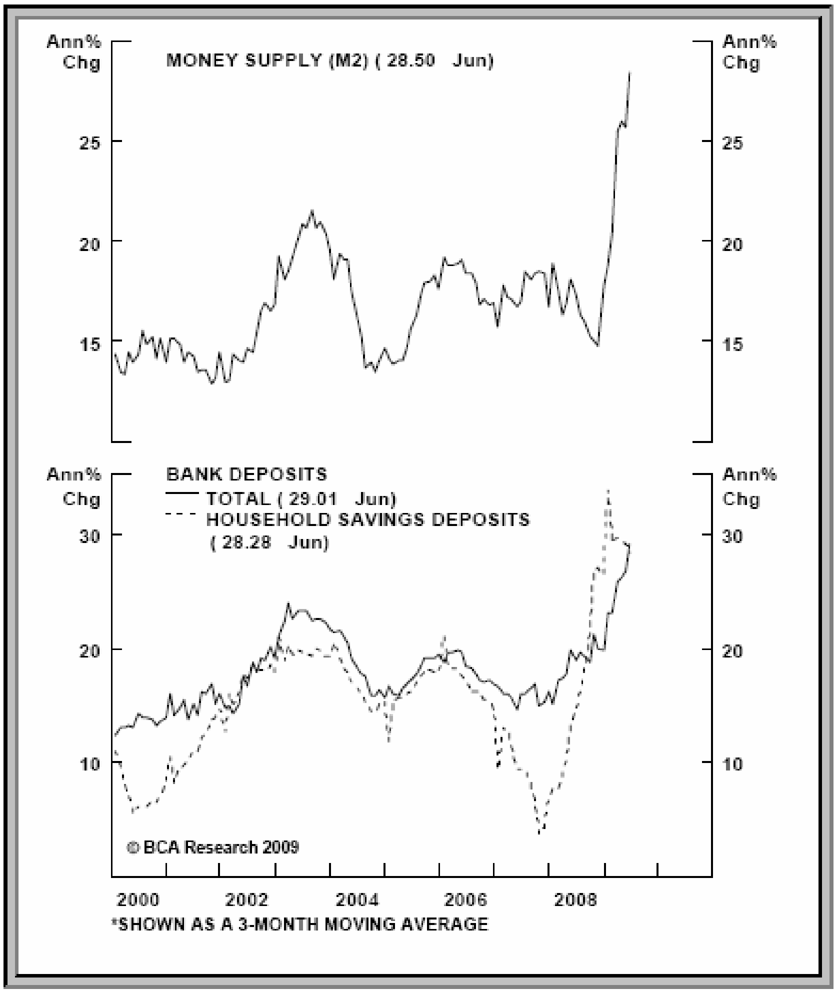
Source: www.decisionpoint.com

Moreover, under a scenario of hardly any economic improvement the following should be considered. Larger fiscal deficits and further money printing is unlikely going to be favorable for government bonds in the long term. Poor economic conditions are equally not favorable for industrial commodities. Cash with no yield is also a poor investment.

So where will money flow? Neither in these asset classes (commodities are likely to underperform for a while) nor into the construction of new factories in China and in the acquisition of additional equipment, but into equities and into corporate bonds.

I mentioned above that stocks are rallying because of still poor economic conditions. This also applies to China where the economy is certainly not expanding at an annual rate of 7.8% (see Figure 12).

Figure 12: Soaring Money Supply in China Is Driving Speculation!



Source: The Bank Credit Analyst

A friend of ours, Vitaliy Katsenelson, Director of Research at Investment Management Associates in Denver, did the math about Chinese growth. According to Katsenelson, "the non-net-export economy (about 90% of the total) would have to grow at about 11% to offset declining net exports and for the total economy to grow 8%. Here I am assuming that exports and imports declined at the same rate." Katsenelson thinks that "the Chinese government is lying through its teeth about its economic miracle growth. It has the incentives to interrogate economic data until it confesses to the party line numbers. This is very plausible, as for months, the Chinese government was showing positive GDP growth while its consumption of electricity was declining. Obviously this doesn't make much sense. Also, China is not famous for the production of intellectual type goods (i.e. software, creation of toxic financial products – that is our specialty) which scale a lot better and don't require proportional electricity consumption to grow GDP. China makes stuff and to make stuff you need a lot of electricity." So, whereas the Chinese stimulus has likely had a minimal impact on the economy, it certainly fostered speculation in equities (see Figure 13).

Figure 13: China's Stock Trading Volume Exceeding on some Days NYSE Trading Volume!

Source: Chris Wood, CLSA

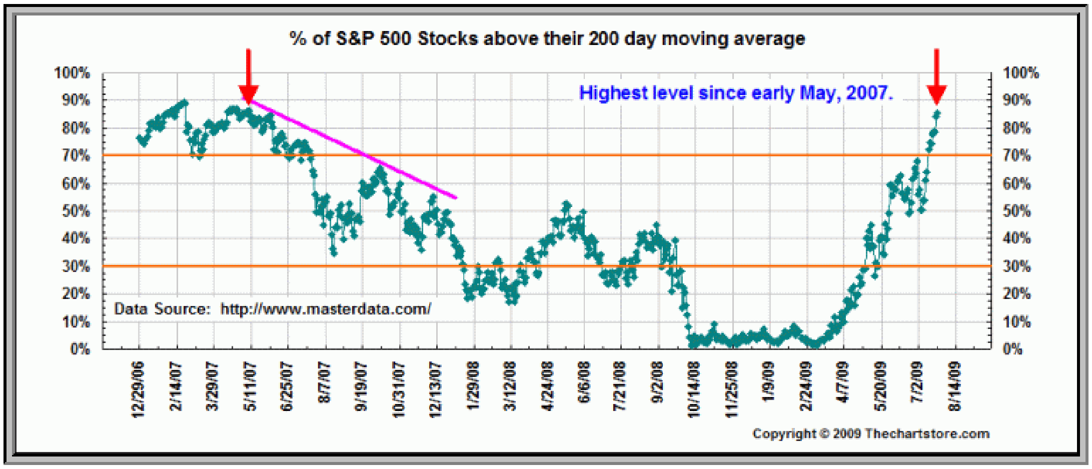
According to Chris Wood, "China stock market trading volumes in the A share market are exploding, helped by the recent popularity of equity index mutual funds in the mainland market" (on a recent day the total trading volume in the Shanghai and Shenzhen stock markets was US$48.5bn
compared with total US trading volume of US$44.3bn and total Asia and Japan trading volume of US$39.3bn on the same day)…… "Still the longer term point represented by this surge in mainland A-share trading is that China is likely to be at the epicentre of any future asset bubble in Asia." And since the Chinese stock market already bottomed out in late October 2008 and led world markets higher, it is likely that the first signs of an intermediate (or longer-term) market top will manifest themselves in China (see Figure 14). An indicator could be that in a week in mid July individuals opened 484,799 stock trading accounts, the most since January 2008!

Figure 14: China's Stock Market Leading World Markets

Source: www.decisionpoint.com

So, where does all this leave us? On a near-term basis all equity markets have become extremely overbought. In previous reports I maintained that markets would rally toward the end of July and that the percentage of S&P 500 stocks above their 200 day moving average would need to increase to above 80% for the market to reach an intermediate top (see Figure 15).

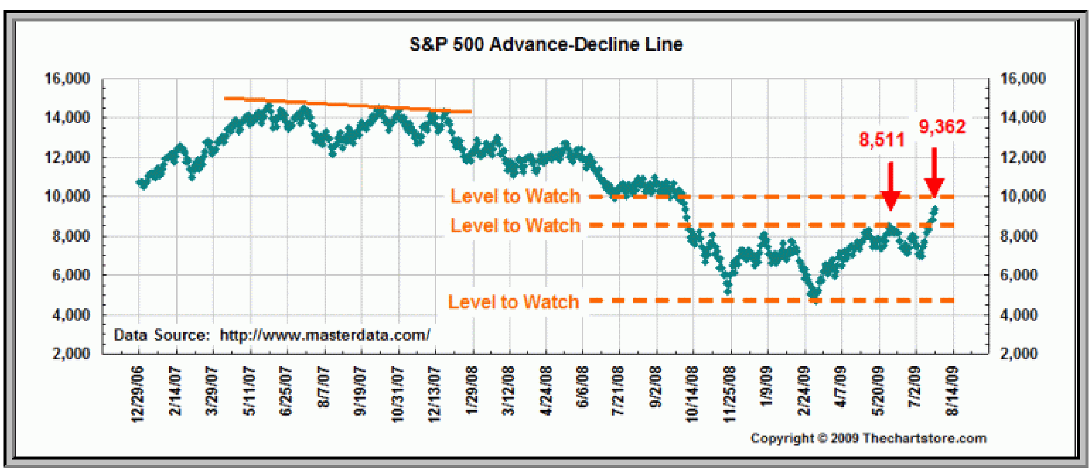
Figure 15: Stock Market Is now most Overbought since 2007!



Source: Ron Griess, www.thechartstore.com

However, the overbought position of the market at this stage of the cycle does not imply that, following a correction, the market cannot move higher. The advance-decline line has clearly confirmed the rally (see Figure 16).

Figure 16: Stock Market Advance Is Broadening!



Source: Ron Griess, www.thechartstore.com

A reader of ours asked us recently a practical question. What would we do had we totally missed the rally? Since the intermediate top on June 11 of this year the S&P is up another 3%. As Alan Newman (alan@cross-currents.net) points out, non-program trading volume remains disappointing, but speculative intensity has increased to record highs not seen since the NASDAQ bubble in 2000 (see Figures 17 and 18).

Figure 17: Low Volume in Non-Program Trading

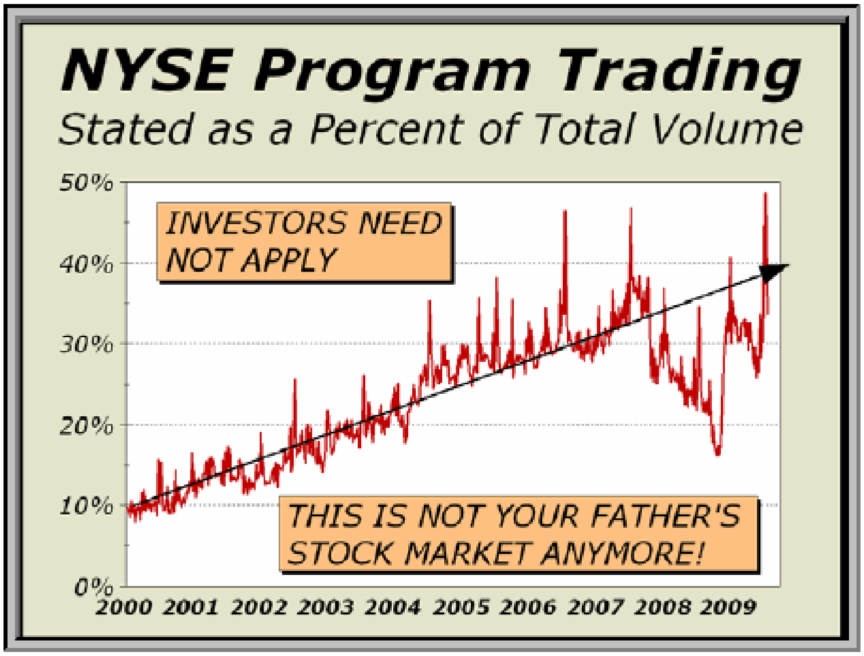


Figure 18: Extremely High Speculative Intensity

Source: Alan Newman, www.cross-currents.net

Moreover, as Peter Boockvar, equity strategist at Miller Tabak notes, the 14 day Relative Strength Index (RSI) in the NASDAQ 100 Index is as of now at the highest level since January 2000 while the RSI in the S&P is at the highest level since May 2007.
The excellent technical service of the Notley Group, which called the rally since the March lows, also suggests that the short term recovery, which got underway in early July, is nearing “a climatic top” and that “at a minimum, it would be prudent to wait for the next short term downtrend to better reveal the real market condition” (contact info: bonnie@yeltonfiscal.com).
This is also my feeling because whereas at the intermediate low in early July of this year (S&P 500 at 879) sentiment had turned negative, now a very large number of investors are convinced that the bull market is for real and that further strength is a given. Another reason for near term caution is that the likelihood of a US dollar rebound has increased (see Figure 19).

Figure 19: US Dollar Strength = Weakness in Equities

Source: www.decisionpoint.com

As of last week, the net number of contracts speculators held betting on a decline versus a rise in the value of the US dollar against currencies traded on the Chicago Mercantile Exchange (CME) was nearing extremes, which in the past was associated with at least a temporary US dollar rebound. And since US dollar weakness accompanied the stock market rally since early March, dollar strength is likely to occur simultaneously with a stock market correction.

So, in sum, if I had completely missed the stock market rally since March, I would, given the high volatility I expect, wait for a more favorable entry point. And if for some reason, buying could not be postponed (peer pressure), I would stick for now to the highest quality companies, in which an investor could average down without hesitation should the stock market sell-off once again. But, as I indicated in earlier reports, I do not expect new lows for the year. Corrections should therefore be used to accumulate equities. An extensive list was provided in the May report. However, I doubt that resource stocks will perform well in the near term.

And yes, I still like gold. But like other resource stocks I do not expect it to move sharply higher in the period directly ahead.

Also, I am enclosing a chapter of Richard Karn's soon to be released new book "Credit and Credibility" (rkarn@emergingtrendsreport.com). It is worth a read in the context of a quote my friend Lance Lewis, who publishes an excellent daily comment, sent me (llewis@lewiscapital.net). In "Democracy in America" Alexis de Tocqueville wrote almost 200 years ago, "the American Republic will endure until the day Congress discovers that it can bribe the public with the public's money."

The Monthly Market Commentary