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What is Mr. Market Telling Us?

Maybe just maybe Mr. Market has it right and all the economists have it wrong. Stocks are on a tear and investors seem to be betting on a more robust economy than almost any economist or market strategist. The widely touted date for the market's low was March 9, 2009 when the S&P 500 closed at 676.53. But the actual flush-out of sellers occurred three days earlier when the index reached a devilish 666 on 3/6/9. Eerie numbers, right you "Code" fans? Today it trades at 989, just 10 points from 999. Humm?

The market has rallied 48% from the lows just mentioned, yet backward-looking economic reports continue to reveal a sinking economy. In fact, the government just released newly revised estimates showing the economy shrank more than twice what was forecast. The US economy contracted 1.9% from the fourth quarter of 2007 to the last three months of 2008, compared with a 0.8% drop previously on the books according to the Commerce Department today. They also released their first estimate for the second quarter which showed that the economy shrank 1%. The decline compares very favorably to the 6.4% drop during the first quarter of 09, the worst in 27 years and comprising the worst recession since the Great Depression. The end may really be in sight.

The gross domestic product reports had some good news on the fundamental health of consumers. The numbers showed that Americans earned more over the last 10 years and socked away a larger share of that cash in savings. Given that they've experienced the largest drop in household wealth in history it's a good sign that they are taking care of the fundamentals first. As a result of their more frugal ways, it's fair to predict that will not return to their free-spending ways any time soon.

The job market is a major component of what comprises consumers' moods and the recent numbers are not reassuring. Yesterday's release of the Consumer Confidence Index showed that the number of survey respondents who said that jobs are hard to get grew to a near-17-year high of 48.1%. According to strategist Ed Yardeni this response has been one of the best indicators of labor market conditions. He says it is highly correlated with both the unemployment and underemployment rates and it does not get distorted with seasonal adjustment problems. This point provides credence to the Labor Department's warnings that the improvement in unemployment claims of the past few weeks is probably due to distortions caused by the earlier-than-usual auto industry layoffs.

The other major component of consumer mood is housing. On this front, consumers may be doing better, or at least not as badly as they have been. The collapse in prices may be coming to an end, but don't expect any sudden snap-backs. Housing sales are dependent on jobs, credit availability, appraisal values, and interest rates. None of these show signs of improvement.

Dr. Yardeni points out that during normal times, sans bubbles, “home values tend to be strongly influenced by the cost of renting a house or apartment. Higher rents tend to convince more people to buy than to rent their dwelling.” When the unemployment is high, inflation driven by wages tends to decline, which in turn drives rent inflation lower. Landlords can’t charge as much when people are losing their jobs. So, apartment rents are NOT driving people towards houses.

But, you say, prices in home values seem to have stopped dropping. What’s the reason? Perhaps it’s simply that they’ve reached their point of equilibrium. Bear markets do not last forever and generally go too far, just as bull markets do. Prices have dropped 25-35% from their bubble peaks. Yardeni points out that household formation in this country is about 1 million units per year, even during bad times. That’s huge demand for houses – new and old, especially at current prices and government incentives.

Look at the immediate success of the cash-for-clunkers program. If the goal was (to spend lots of taxpayer money) to move lots of cars that were not selling, it’s working. Everybody loves a bargain, especially if they can spend someone else’s money to get it. The first billion dollars of the program have been exhausted in a far shorter period of time than was expected. The Obama administration is seeking ways to take, I mean get some more money for the program as they meet today with congressional leaders “to find and develop ways to continue to fund” the auto discounts, White House press secretary Robert Gibbs told reporters today.

We can still count on consumers to take the bait when it is covered with incentives. We learned that fact during the last recession when the auto companies gave their cars away with 0% financing. But these are short-term one-time pops and will not lead to sustainable spending.

So what about the emerging market economies that depended so heavily upon US consumption before the collapse? Stock investors do not seem worried. They must believe that the governments of these fledgling economies, especially China, are successfully stimulating their domestic demand. Their internal stock markets certainly support this notion. Brazil, Taiwan, and China are up 71%, 50 %, and 50% year-to-date respectively. The market obviously sees potential in a global recovery led by China and other emerging economies.

Corporate earnings continue to suggest improvement and on a widespread basis. While some can be attributed to cost cutting, which is what companies do in recessions, growing profits at more US companies are attributed to their efforts in emerging economies. Intel and other companies, primarily tech, point to significant growth abroad, particularly China.

Mr. Market is predicting recovery, not so much from the US consumer, but through the corporate sector and its growing success abroad. We may be in the midst of the first post-war global recession where the US doesn’t lead the way out of recovery. Maybe we’ll simply have to settle for any recovery is a good recovery. On the plus side, as China’s growth continues to outstrip ours, dollars might just begin flowing back home. For now, we still make the best computers and software (as well as a host of other categories) in the world. These new consumers will have to buy from someone, why not the best? Have a good weekend.