Recoveries Can Happen . . . Part II

U.S. Market Chart Stack

Jeb B. Terry, President

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Caution: It's a risky world we live in. My opinions are based on information believed to be reliable but hey, I could be wrong. When investing, try to use good judgment and don't hesitate to seek professional assistance. Remember to set limits and have a plan. . . Good Luck!

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Is "The" Bottom Forming? . . . Will There Be a Recovery in 2009?

After setting a panic low in November, the S&P 500 had a furious recovery of 27% to a January high. It has since corrected 19% and broken the November low . . . Are we at the final low? Are we headed into the Abyss? Will the market still recover?

S&P 500:
- Down 50% from 2007 high
- Down 18.6% YTD
- **Now down 1% from the November Low**

I wrote a piece entitled "*Recoveries Can Happen . . . Honest*" in mid December 2008. This "Part II" checks on the progress.

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We Are Exiting a "Panic", Not Entering a Depression

Goldman Sachs recently laid out the stages of manias and panics as described by Charles P. Kindleberger in his 1978 book *Manias, Panics and Crashes: A History of Financial Crises* which I reproduce below.

6 Stages of a Financial Panic:

1. Exogenous shock such as technology, financial innovation, regime shift.

2. As profit opportunities are created, credit creation accelerates -new banks enter, personal credit increases, new credit instruments are used

3. This leads to speculation – which leads to overestimation of the true expected return and excessive leverage

4. Speculation spreads from one market to another & internationally (display of psychological mechanisms such as animal spirits, herding mentality)

5. At the peak some insiders leave the market, there is "financial distress" and a bankruptcy or the revelation of a swindle **leads to the final stage; the rush for liquidity**.

6. **The panic feeds itself until** either prices become so low that people are tempted to once again go into less liquid assets OR **a lender of last resort convinces the market that there is enough money for all.**

Have we had a panic? YES . . . Has the lender of last resort stepped up to supply "enough money for all"? YES . . . Does this mean the panic will end? It Should.

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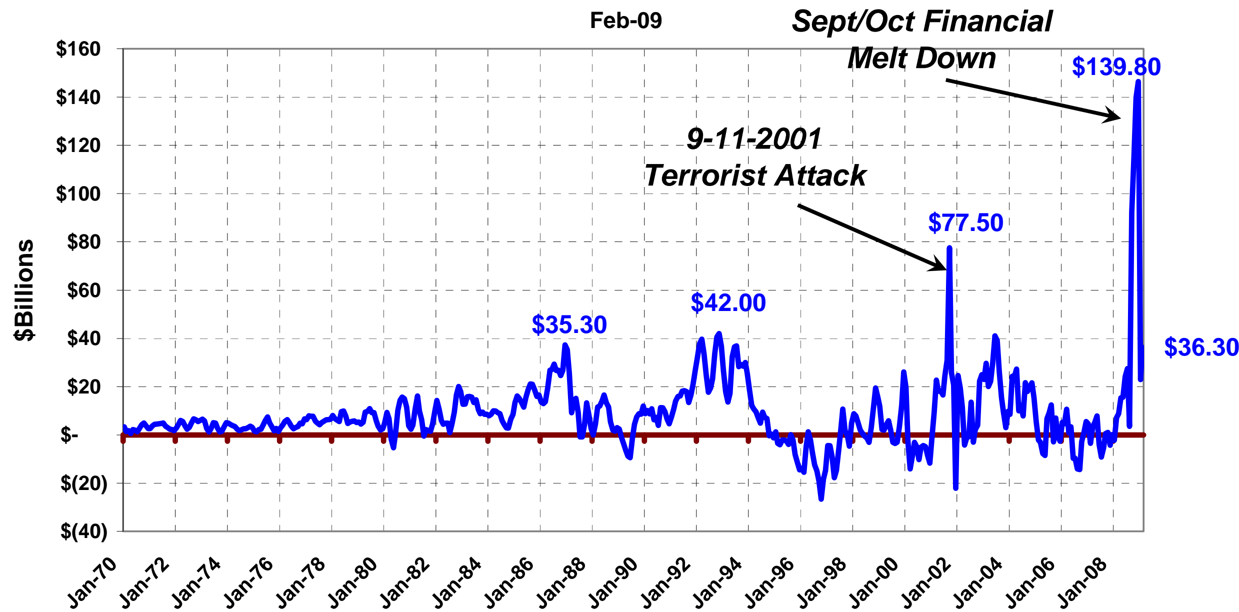
The "Rush for Liquidity" Has Sucked the Air from the Economy . . . *Temporarily*

The shock and awe from the financial meltdown of Fannie Mae / Freddie Mac / AIG / Lehman Bros. and the subsequent seizing up of the capital markets caused an unprecedented panic to sell financial assets and go to cash. It also caused companies and households to retrench and build cash reserves. The growth in M1 – non-interest bearing demand deposits – has been breathtaking. **A key point is that the cash hoarding was sentiment driven which means it can reverse also due to a change in sentiment . . . as it did following 9-11 . . . and it will - soon**.



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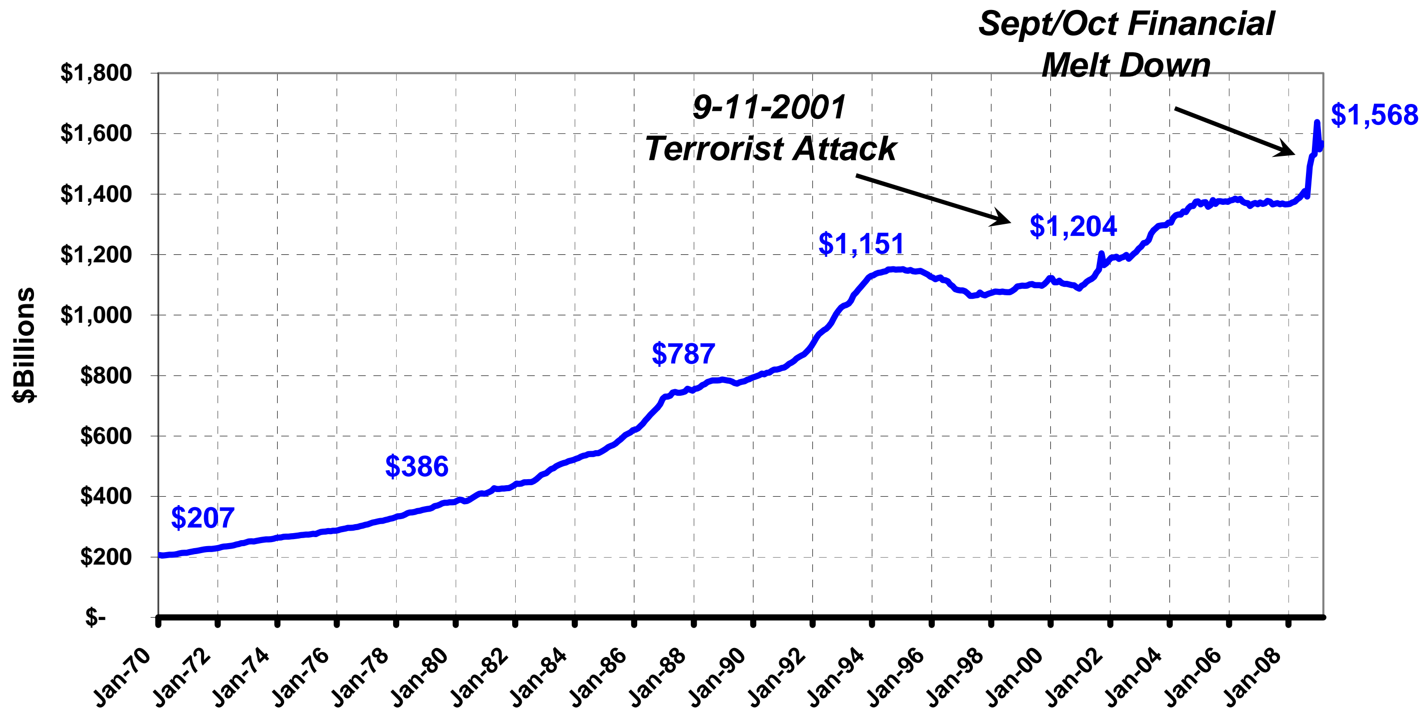
There is no need to keep nearly $1.6 trillion sitting in checking accounts! Cash has very little utility. The amount of cash that one keeps is a function of expected near term expenses relative to near term income. It has zero protection against inflation.



Source: Federal Reserve, seasonally adjusted

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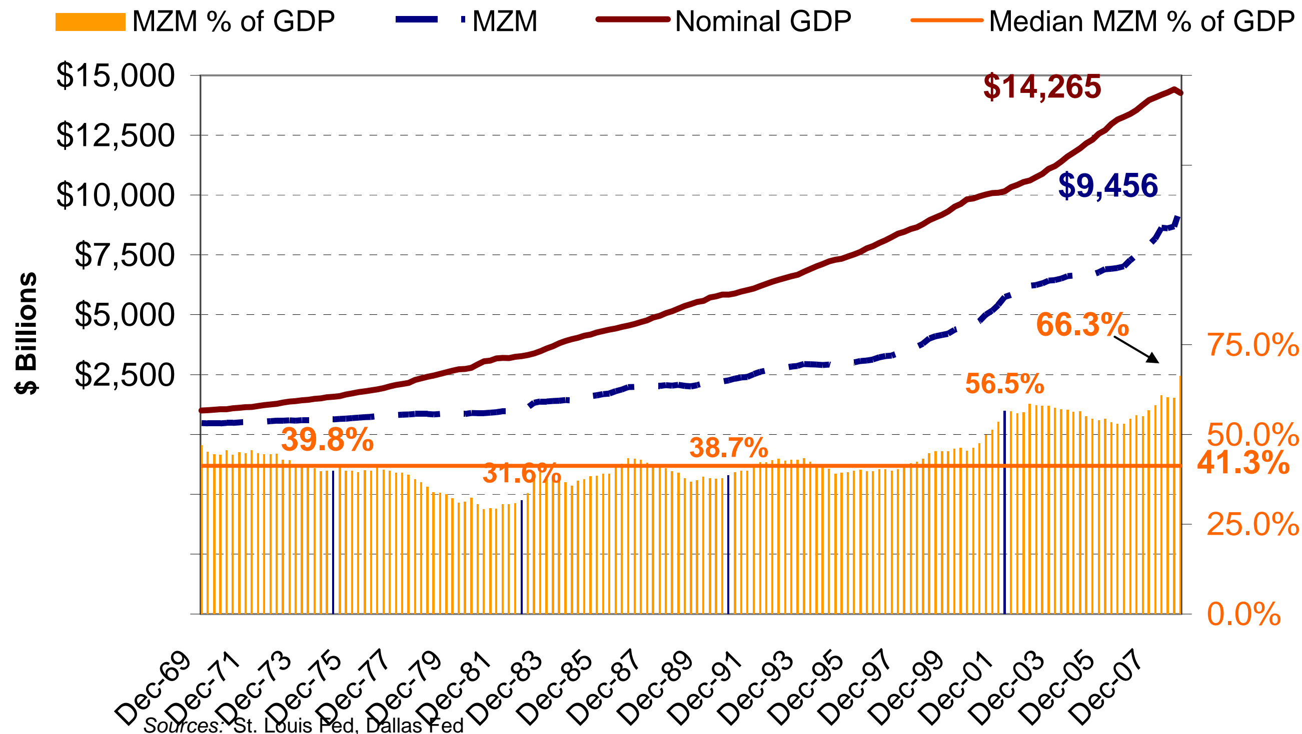
Over $2.9 trillion would be freed up for investment in the economy if MZM were to drop back to the median level since 1969. MZM is "money of zero maturity". It includes M1, small denomination time deposits and money market accounts. The amount of liquidity is the highest on record either in absolute dollar terms or as a percentage of GDP. Over $750 billion has gone into MZM in the since the end of August 2008.



We have never had as much idle cash available on the sidelines to kick start the economy out of a recession

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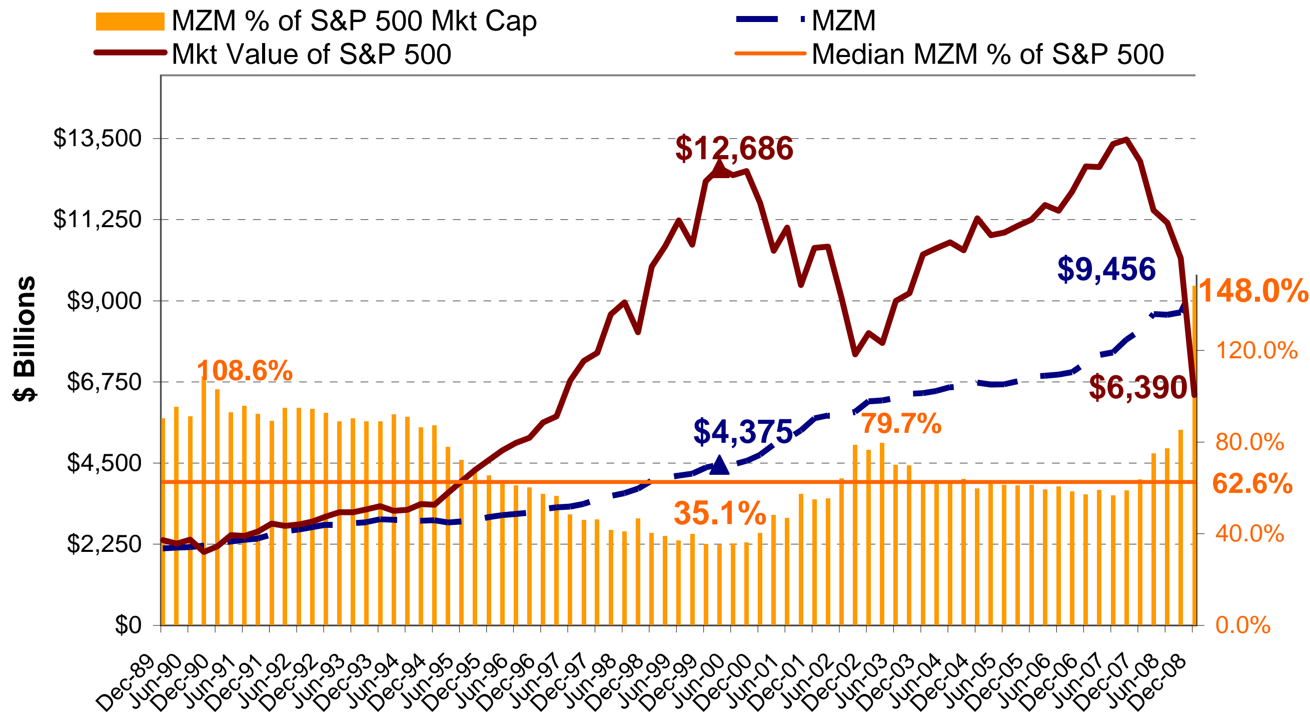
MZM is equal to 148% of the market value of the S&P 500. Returning the stock market to a value commensurate to the median level of MZM as a percentage of value for the S&P 500 implies a gain in market value of 136%. Is that a prediction? NO **Is it reasonable to assume that MZM will return to 100% of the value of the S&P 500 sometime in 2009? . . . There is historical precedent.**



Sources: St. Louis Fed, Dallas Fed

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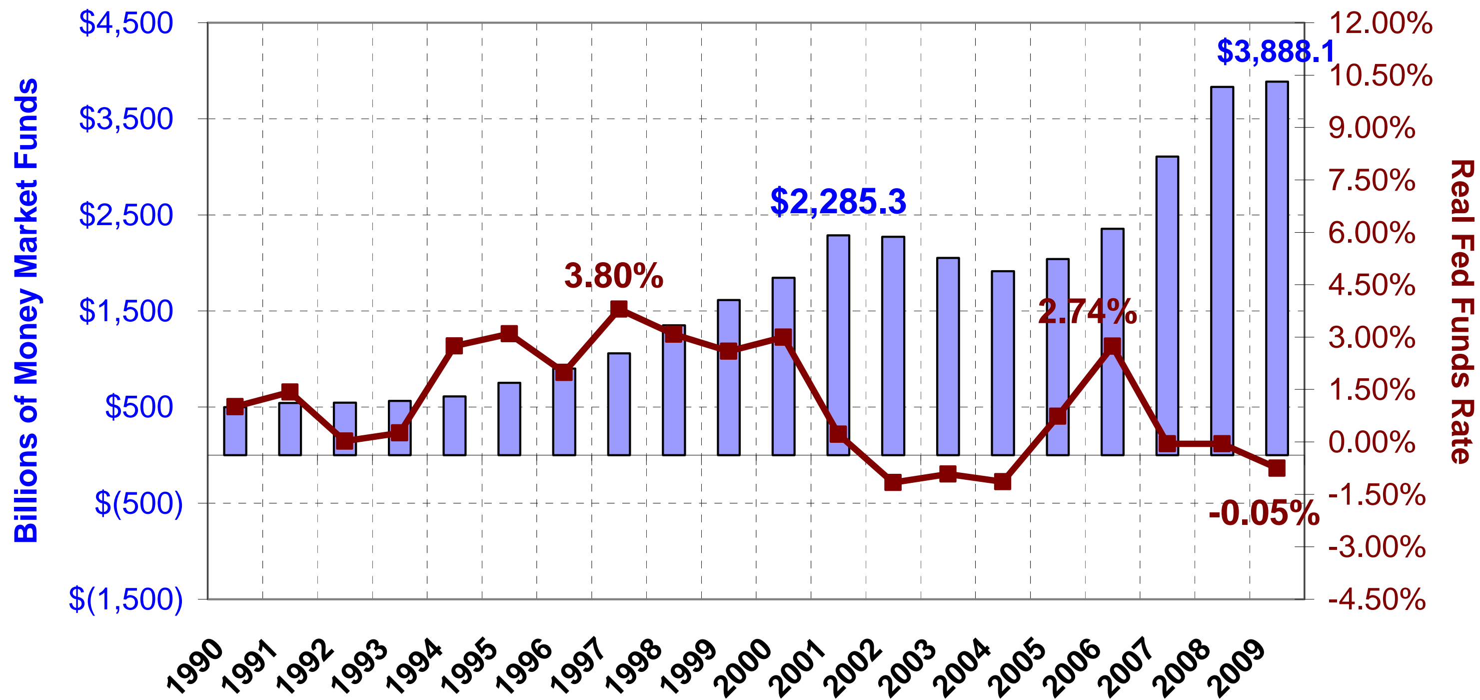
Money market funds remain at record levels earning negative real rates of return . . . Go Figure? This is due for a reversal.



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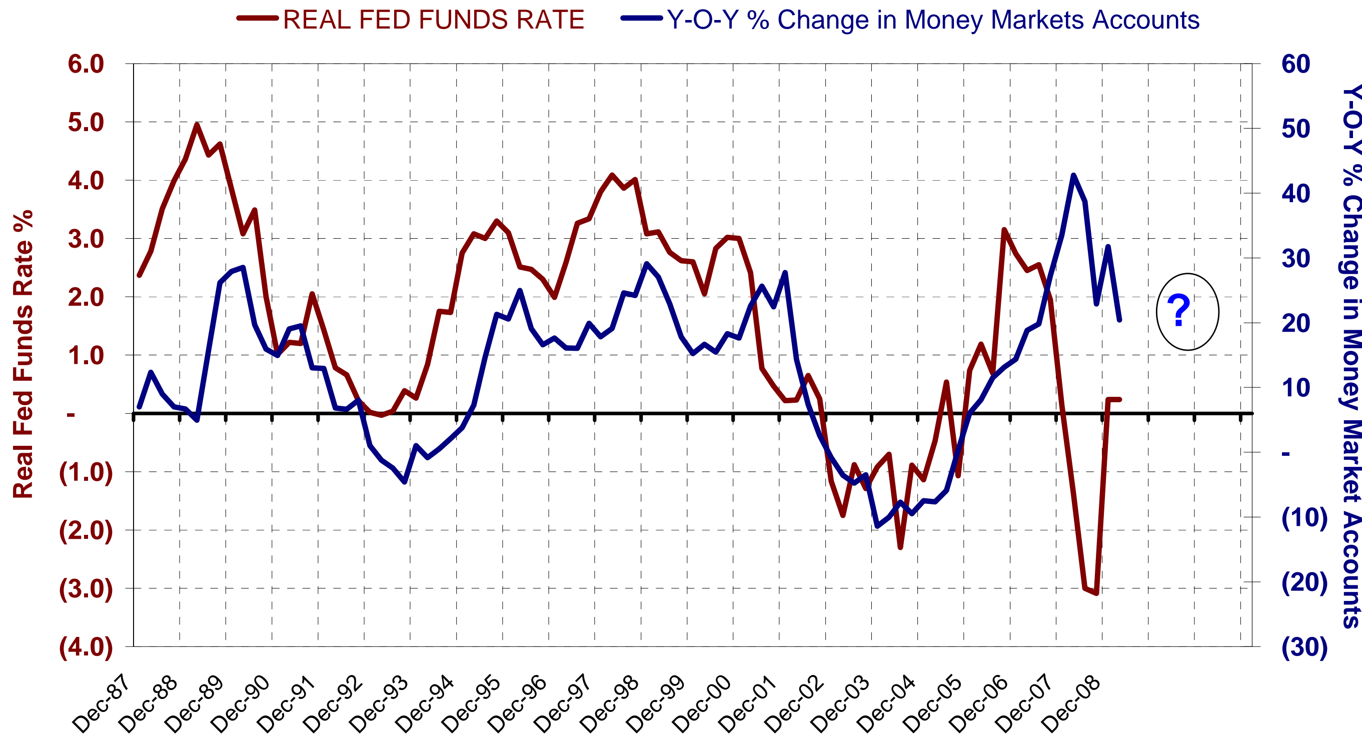
In the past – when the real Fed Funds Rate turned negative, money started to leave money market funds. **A 10% decline in money market fund balances such as we saw in 2003 suggests $387 billion would be freed up for investment in stocks, bonds and real estate.**



Source: Bloomberg, Federal Reserve

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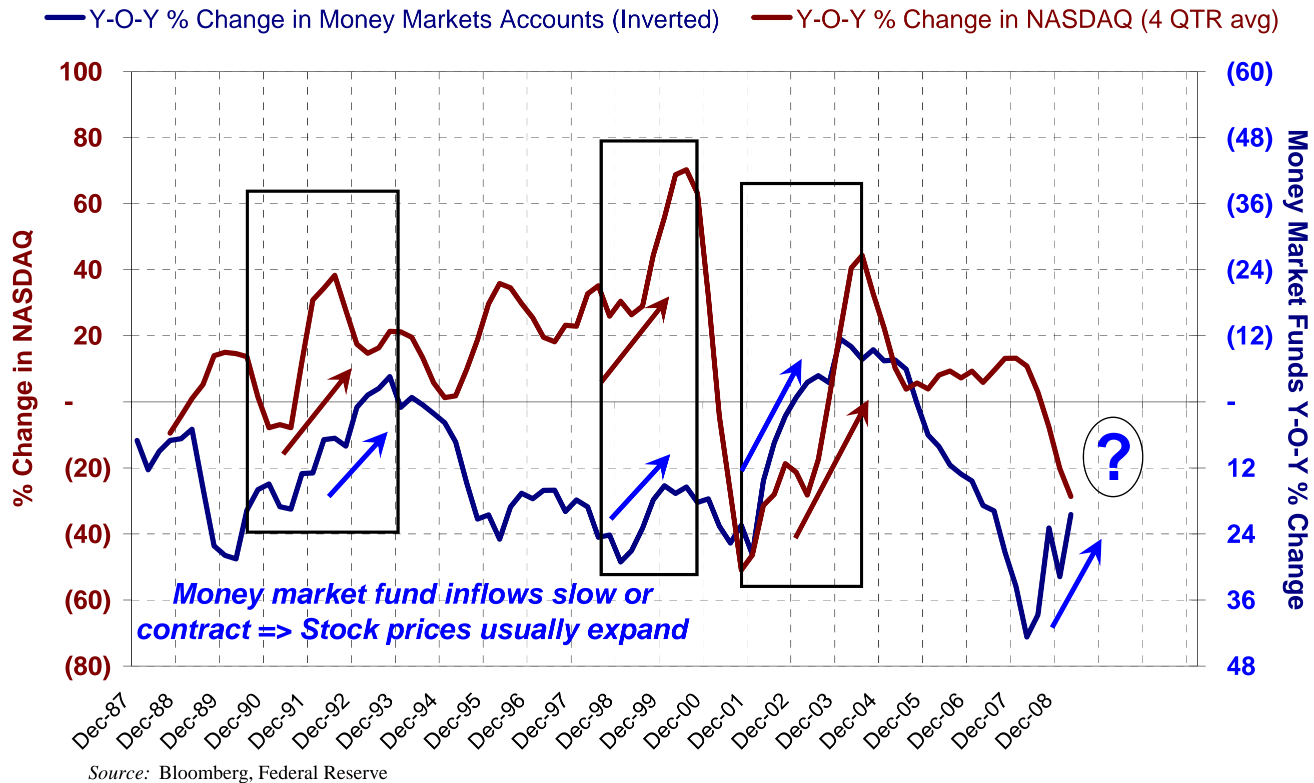
When inflows to money market funds slowed or turned negative, stock prices have tended to go up. Money market fund inflows have definitely slowed . . . Could it be time for stock prices to start moving up?



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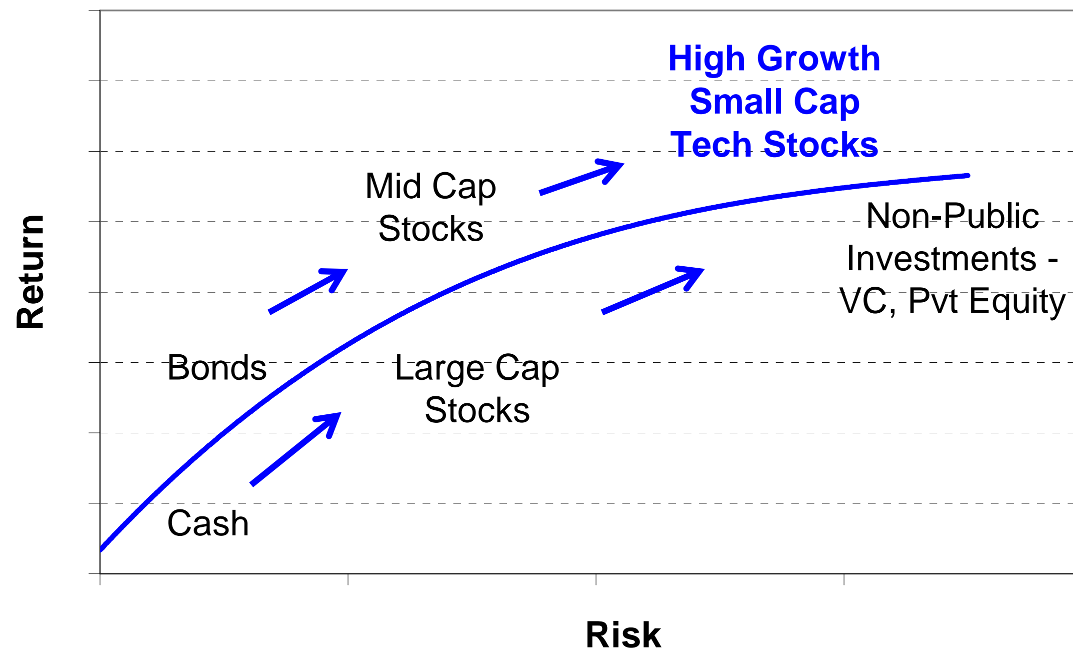
So . . . Where Will All the Cash Go?

It will start to march up the Efficient Frontier. The Efficient Frontier is a theoretical array of all possible investment classes arranged by Risk and Return. The higher the return desired, the more risk one must embrace. There is more money sitting in cash at the bottom of the curve than in the value of all stocks in the S&P 500.



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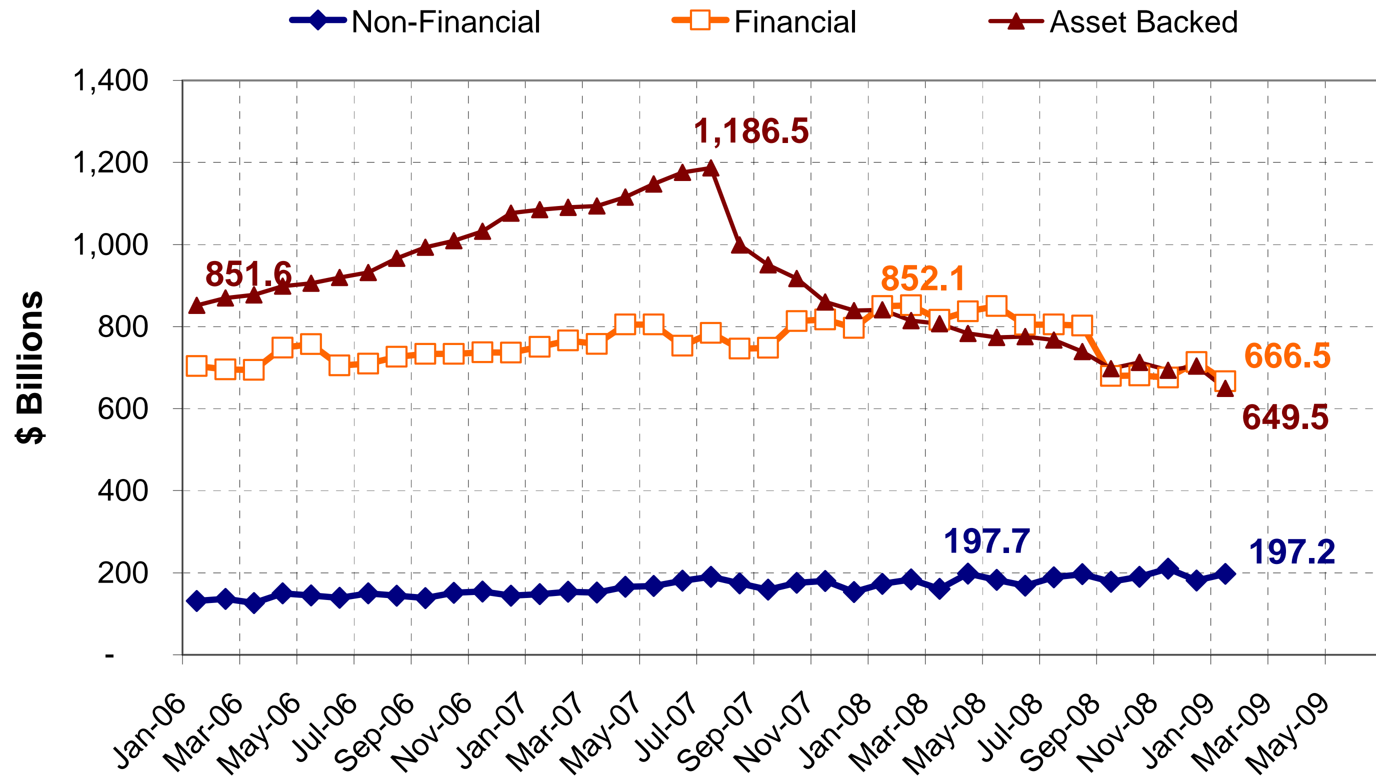
First Stop – Commercial Paper . . . At some point in the near term, the money parked cash and in Treasuries at money market funds will seek yields and buy increasing amounts of commercial paper. The impending TALF facility of the Fed will help restore issuance of Asset Backed paper**.** Recovery of the commercial paper market will help restore a critical funding source for consumer activity.



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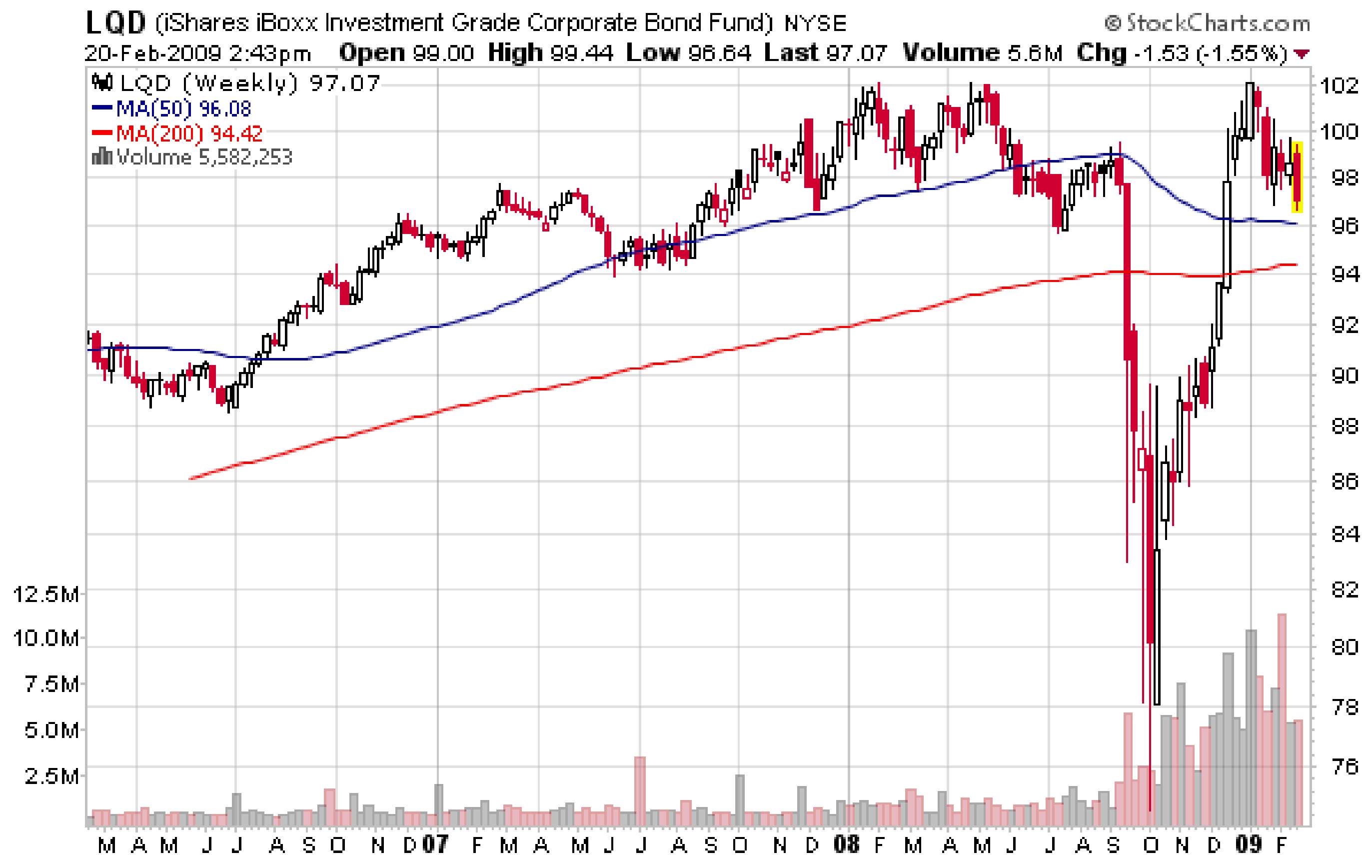
<u>Second Stop – Bonds</u> . . . It seems every strategist on Wall Street is touting bonds. The market for investment grade bonds have recovered sharply from their panic lows from last fall. While I don't prefer them given the prospect of higher taxes on interest income and more inflation down the road . . . the yield starvation in the market today should provide a persistent "bid" for quality bonds – which is a prerequisite condition for equity prices to rise.



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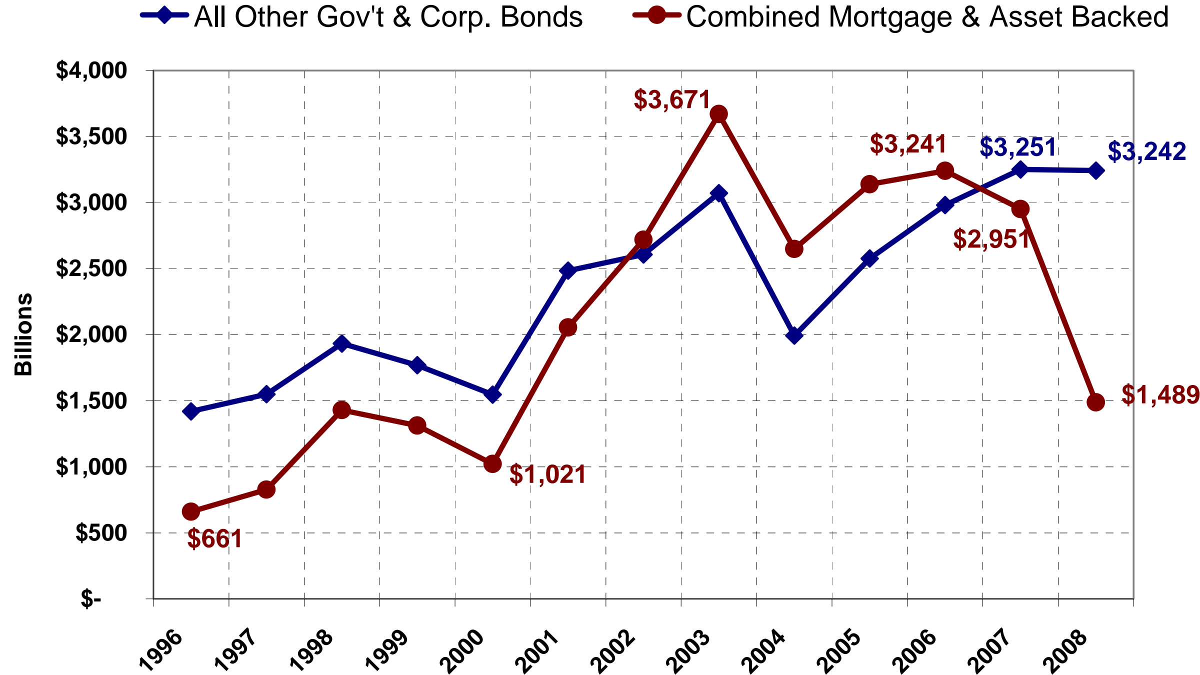
Bonds have appreciated as the supply has shrunk. Total U.S. bond issuance in 2008 shrank by $1.47 Trillion. The collapse in the issuance of mortgage and asset backed bonds has freed up nearly $1.5 Trillion for investment in other long term debt instruments and other financial assets. **Investment grade corporate bond issuance has been reported to be up 23% over early pre-crash 2008 levels. Some new bonds have been over subscribed by 10X.** As was mentioned recently in BusinessWeek . . . "*investors, sick of next-to-nothing Treasury yields and looking to put their large cash stockpiles to work, are eating up the corporate bonds. "You can basically buy high-quality bonds and earn equity-like returns,"*



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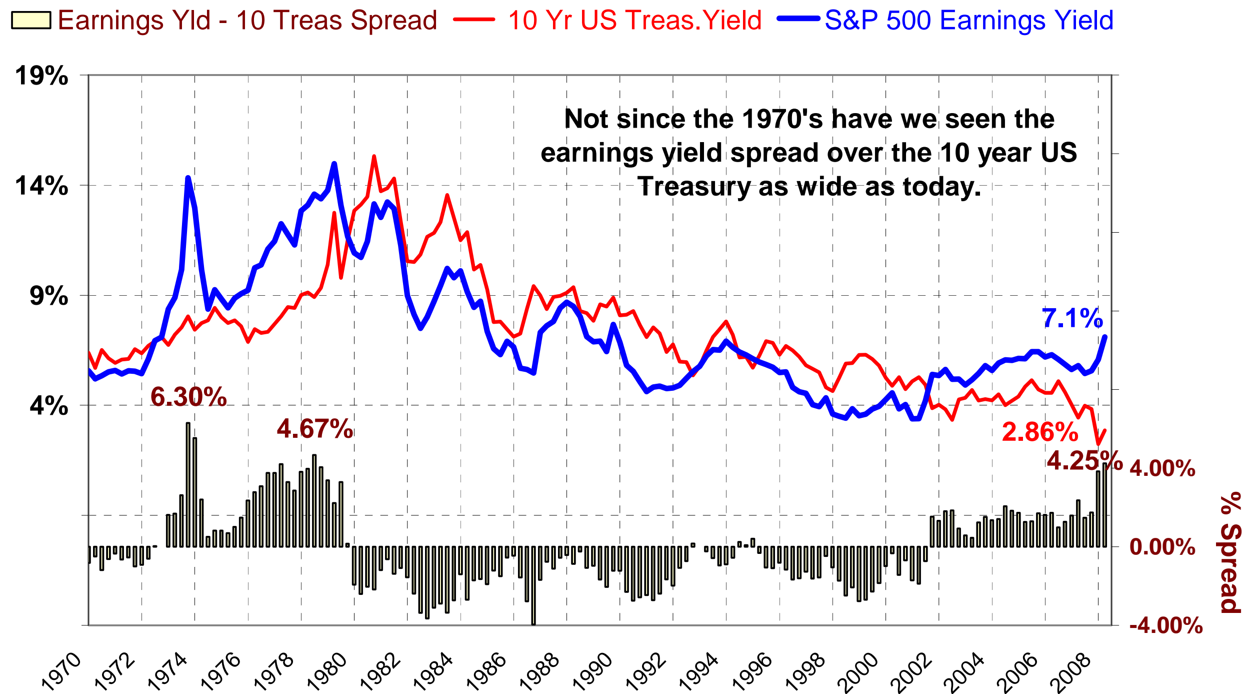
<u>Third Stop - Equities</u> . . . The Financial Incentive to Own Equities Is ENORMOUS!

Following inflows to fixed income securities will be increasing inflows to equities. The Earnings Yield (the reciprocal of the P/E Ratio) exceeds the rate on the 10 year Treasury bond by the most since the 1970's. The spike in the spread over 4% such as today has signaled a gain in the S&P 500 in the following quarter 4 out of the 5 times it has occurred since 1970. The median quarterly gain has been 7.5%.



BTW – the earnings yield at the absolute bottom of the Depression bear market was 6.1% - i.e. LESS than today's.

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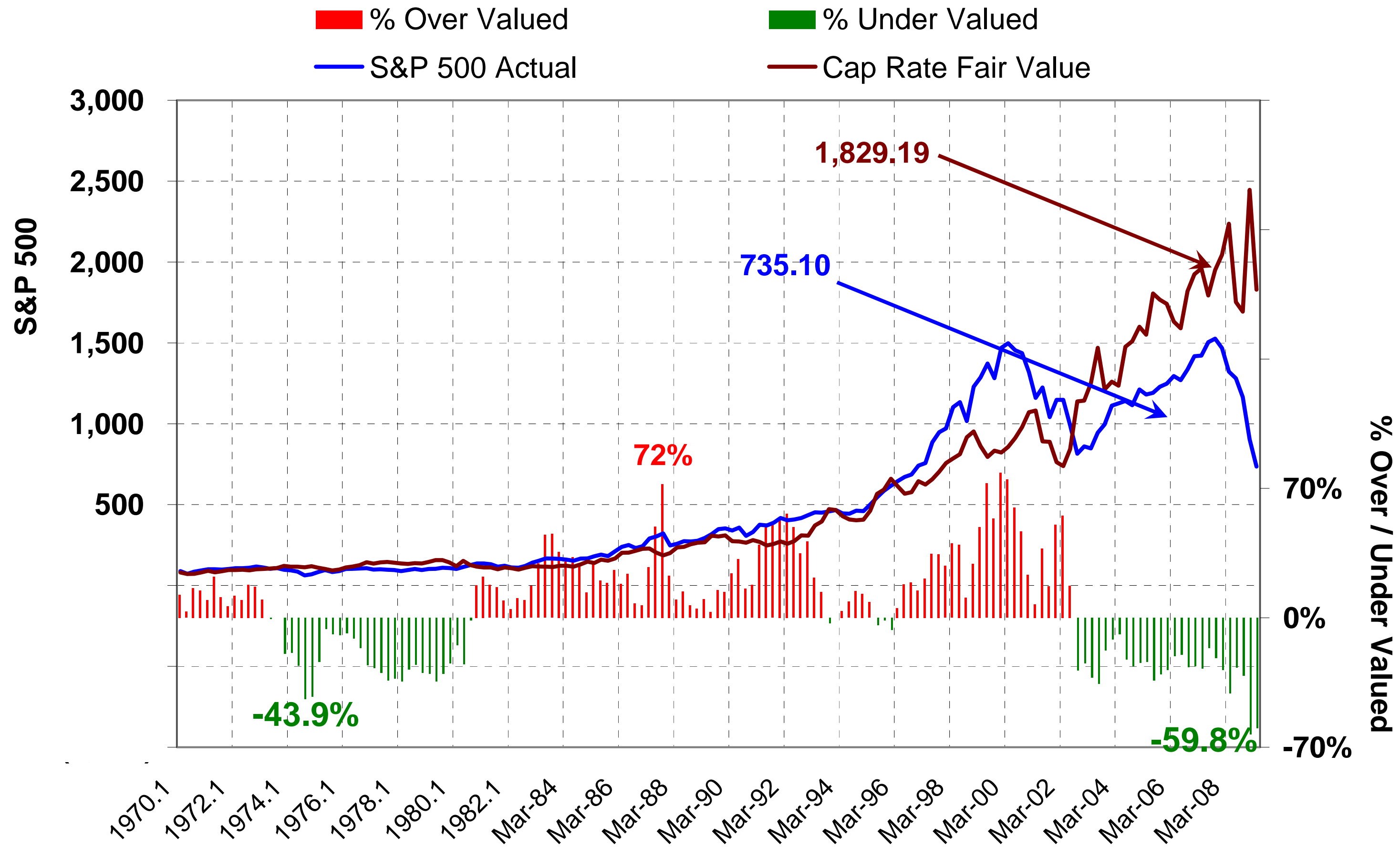
Stocks remain historically undervalued. A proxy for "fair value" of the S&P 500 can be determined by using the rate on the 10 year Treasury as a "cap rate" against earnings. I like the approach as it has limited assumptions and can be applied consistently over a long period. This proxy suggests the market is nearly 60% undervalued. Sharp drops in the valuation proxy have tended to not last more than 2 quarters in a row.



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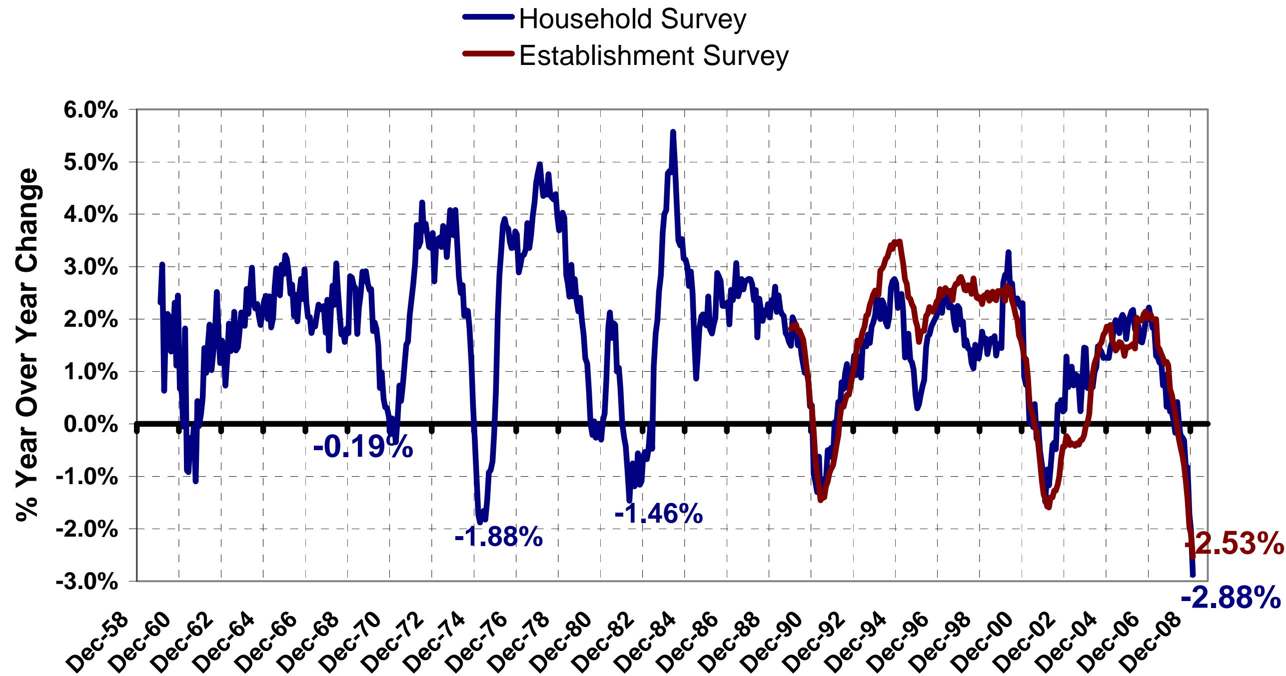
What About Employment? Are There Signs of Recovery Yet?

Employment lags the market. Just as employment has suffered as cash has been sidelined in money market accounts, it will benefit as the cash gets reinvested into "real" assets such as equities, bonds and real estate. We have not experienced as sharp a drop in employment as the current drop since the Depression.



Note the "V" bottoms and the round tops. It is not unusual to see employment reverse upward as fast as it drops.

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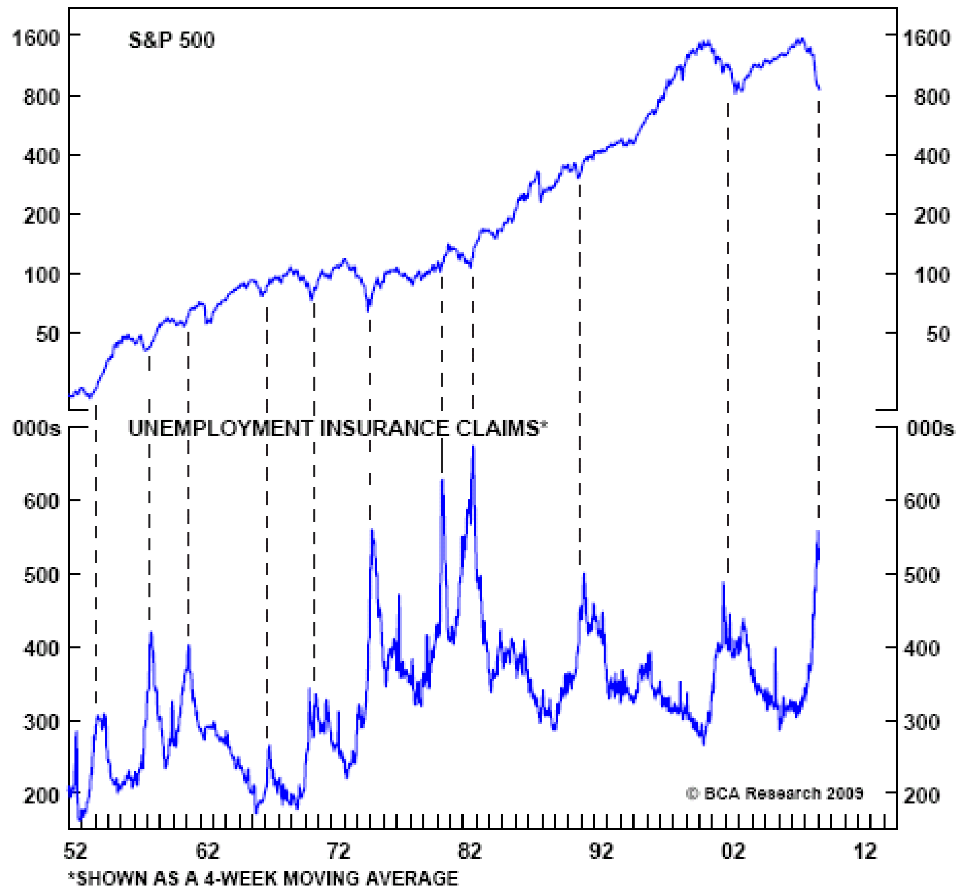
The number of unemployed grew in February and will likely grow in March. We should begin to see strengthening as we move toward the 2nd half of 2009 as the effects of the current aggressive monetary stimulus and the enormous fiscal stimulus passed by the Obama administration begin to take hold. Spikes in employment insurance claims have been coincident with market lows in the past.

CHART 2

A Peak In Initial Employment Insurance Claims Usually Coincides With A Market Bottom



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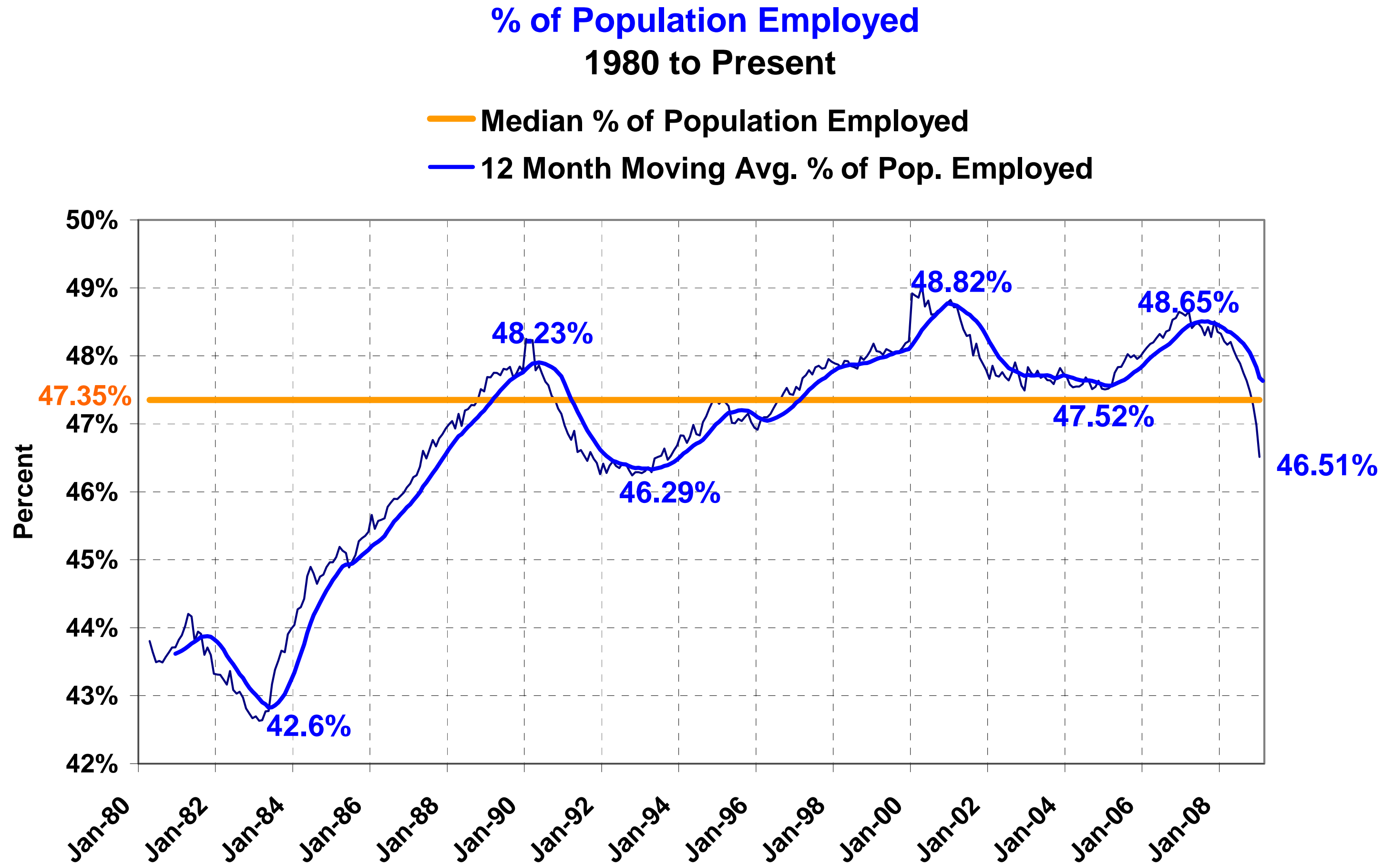
Our economy was tending more toward a labor shortage vs. a labor surplus prior to the current recession.



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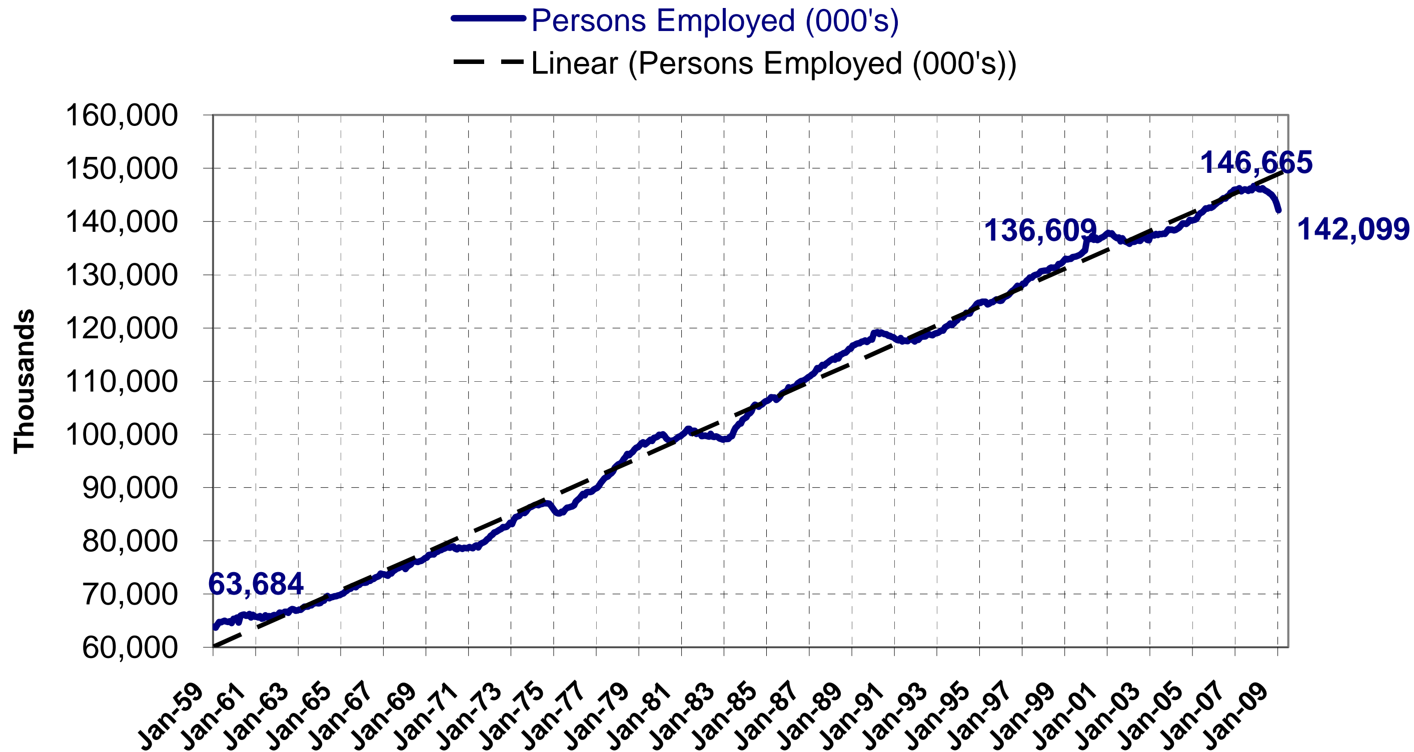
The U.S. remains near the record high level of employment. While the drop in employment has been sharp and severe, 142 million workers represent substantial earnings power.



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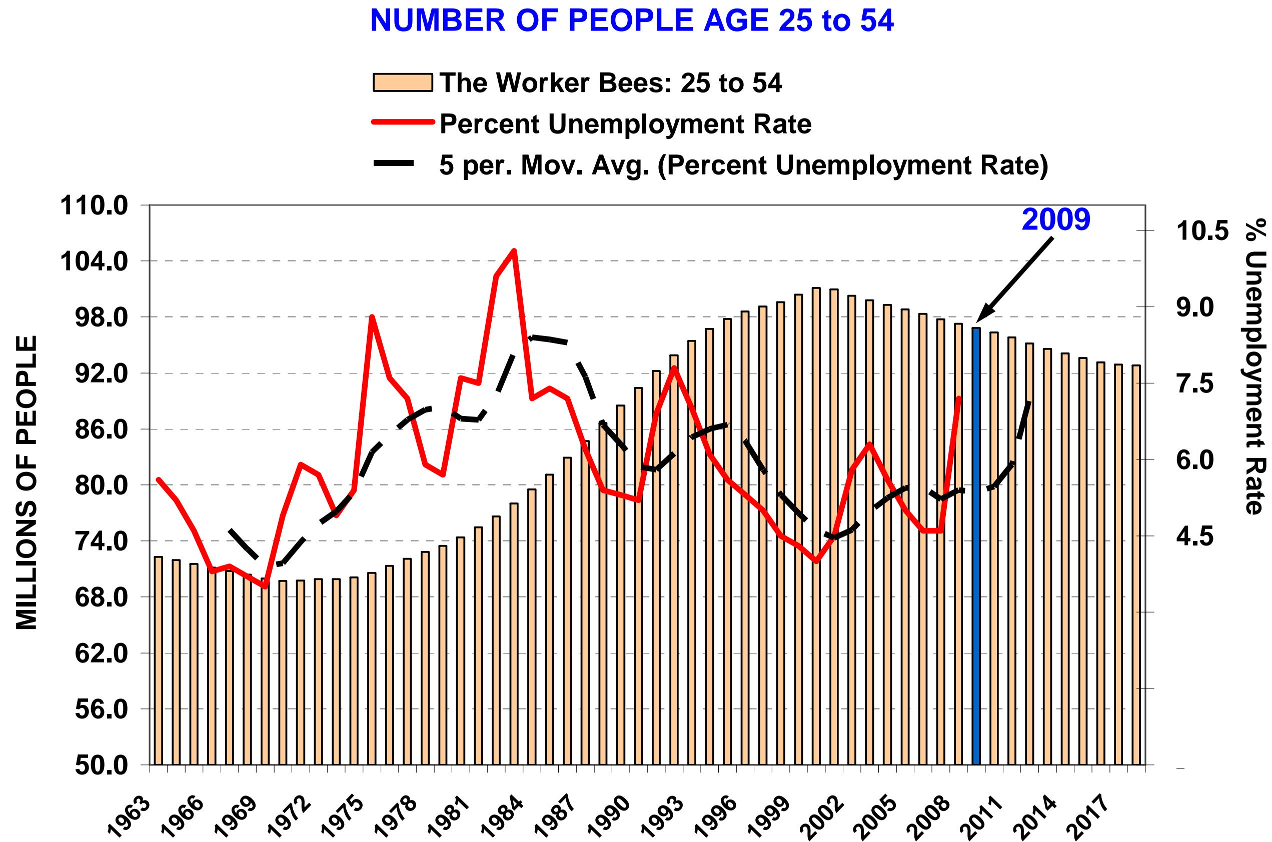
U.S. demography favors lower unemployment rates. The increase in unemployment is inconsistent with the secular decline in the number of "worker bees" in the economy.



Other economic indicators will be well into recovery before labor numbers turn up

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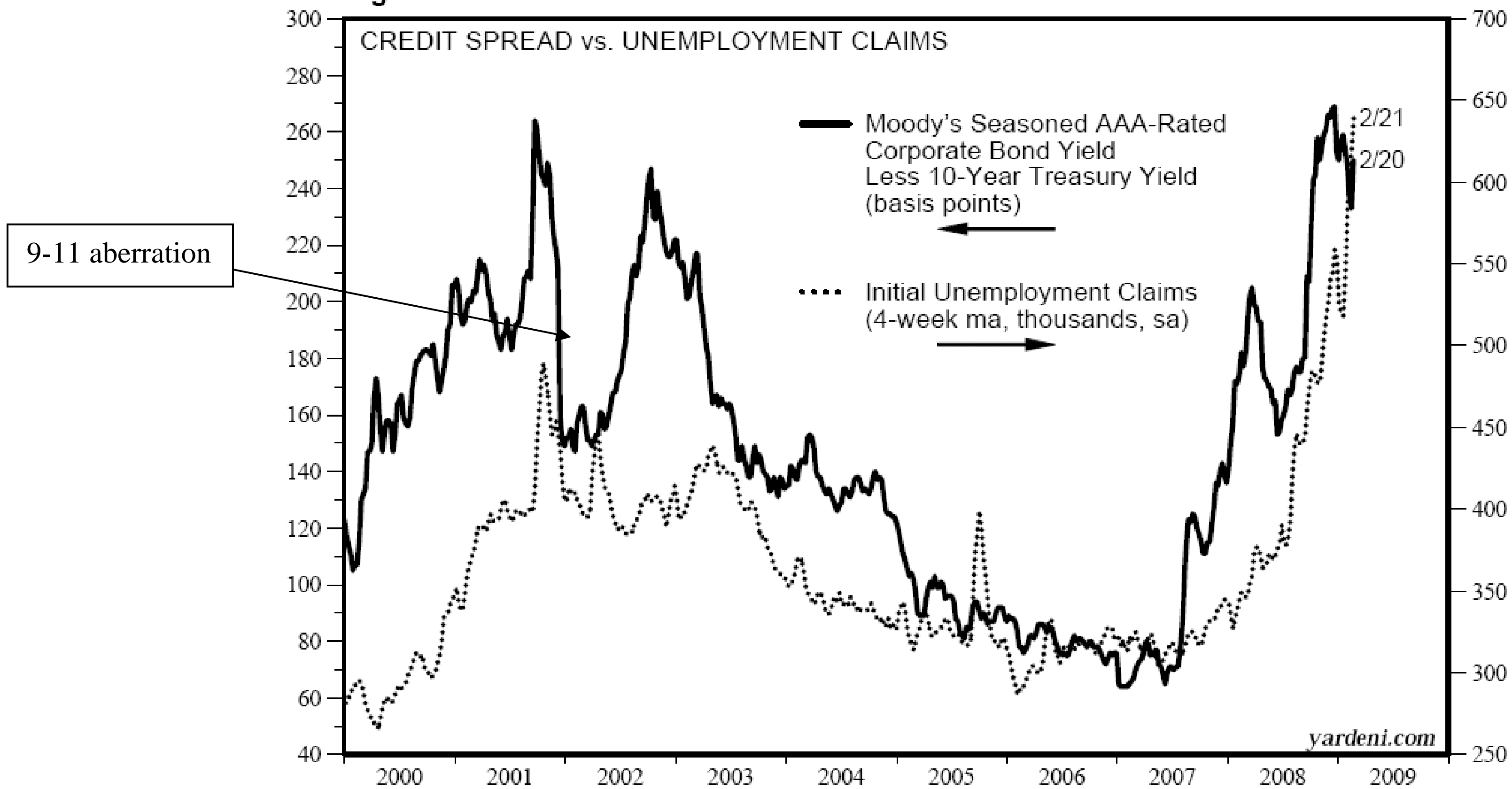
So . . . When will unemployment claims quit increasing? One indicator is the credit spread defined as the difference between interest rates on AAA corporate bonds and the 10 year Treasury. The logic is that when markets gain more confidence in the economy they go in search of more yield and sell Treasuries to buy corporate bonds . . . Hmmm . . . sounds familiar – eh? See “Second Stop” on page 13.



Source: Board of Governors of the Federal Reserve System.

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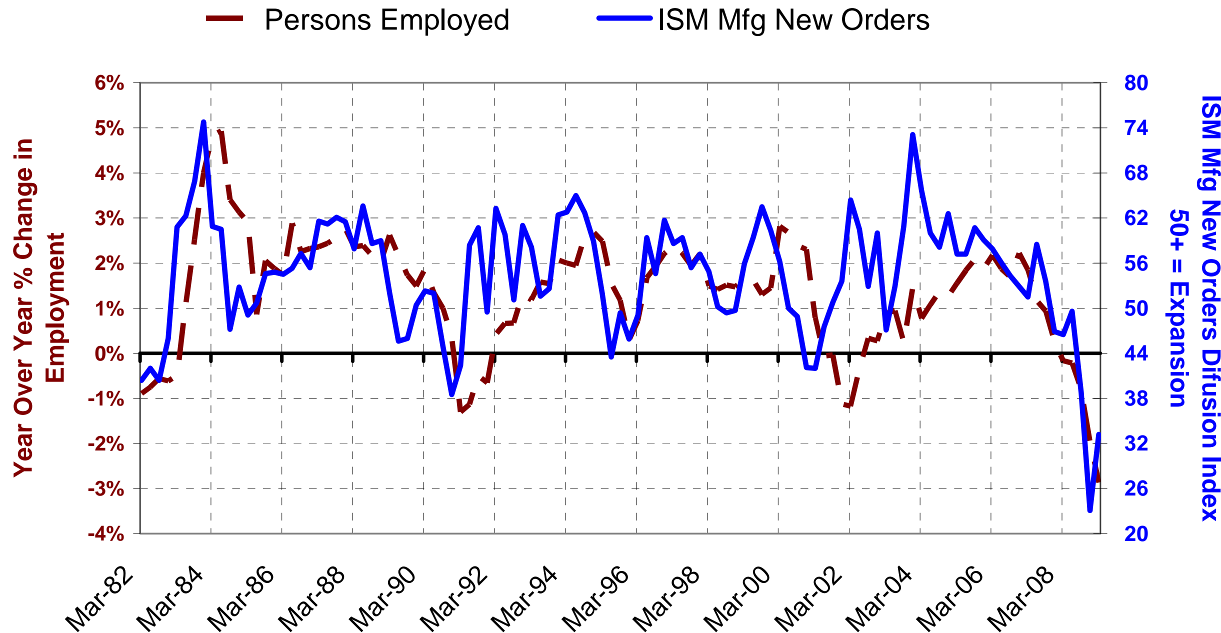
The Credit Spread stuff sounds complicated – Isn't there something easier to grasp that will tell us when to expect unemployment claims will stop increasing? . . . Yep – new orders.
Bottoms in the New Orders index from the ISM Manufacturers' survey have tended to lead bottoms in the rate of change in employment by about 6 months. The New Order index had a strong turn in January. If the index stays as high or higher in the coming monthswe may be able to expect employment to show some firming in the summer months.



Given that we live in a "just in time" world it seems unlikely that the new order index will remain at depressed levels.

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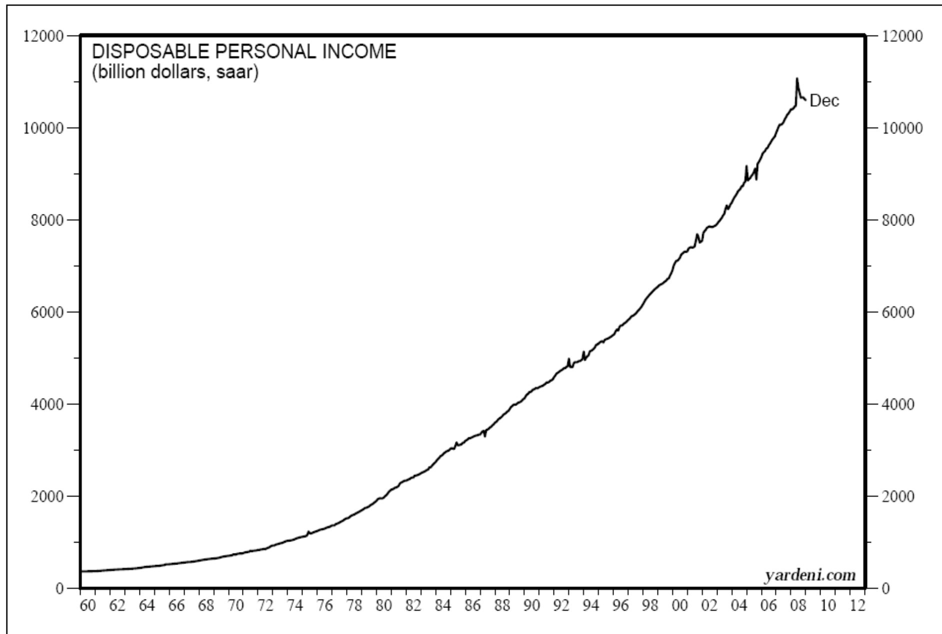
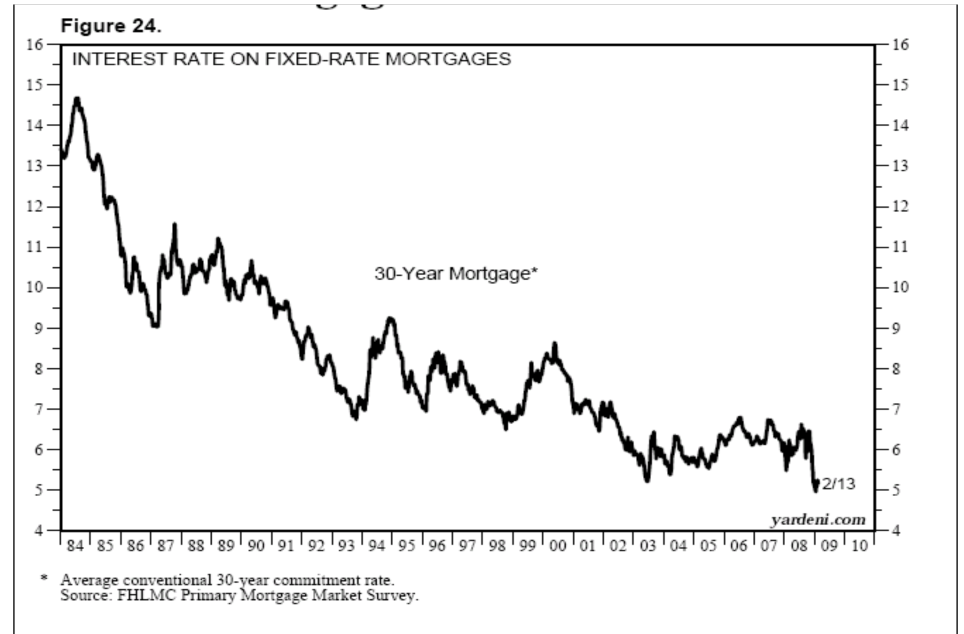
What About the Housing Market? Is It Signaling Recovery? . . .

Rising disposable personal income and falling mortgage rates => Rising home sales. While the level of disposable income may moderate, the level of mortgage rates should stay low enough to sustain incentives to purchase houses and lower adverse impacts of outstanding adjustable rate mortgages.





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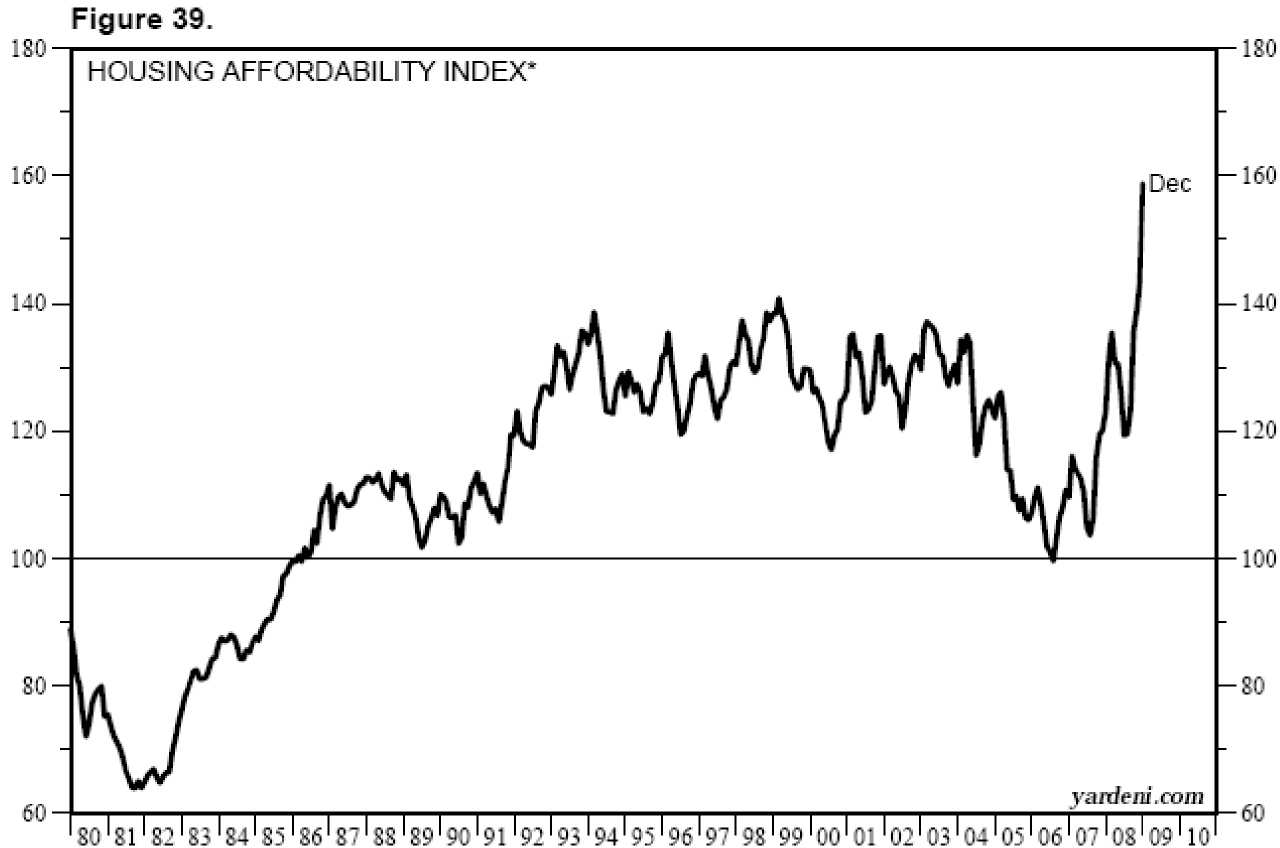
Record high housing affordability index. We have already seen a dramatic improvement in the housing affordability index in recent months as home prices have fallen along with interest rates. The index is already at a multi-decade high and will be even higher when the data is next updated.



* Index=100 when median family income qualifies for an 80% mortgage on a median priced existing single-family home. Rising index indicates more buyers can afford to enter market.
Source: National Association of Realtors.

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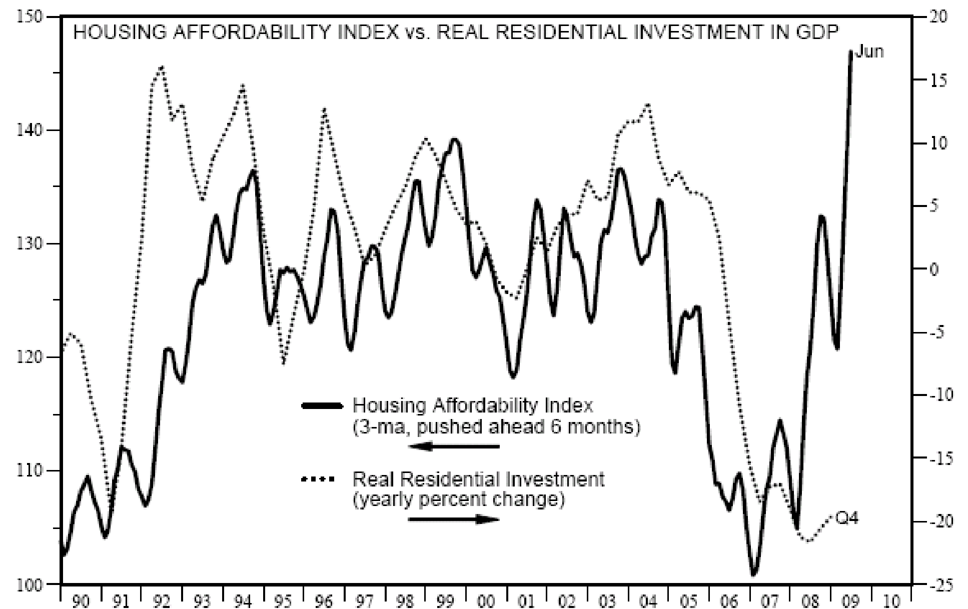
I agree with Mr. Yardeni – high affordability should lead to rising residential investment.
Improvement in housing is imminent if the historical relationships persist.

Real GDP Residential vs. Affordability

- **Housing Affordability Index leads the y/y growth rate in real residential investment in GDP by about 2 quarters.**
- **Affordability has soared 33.1% the past six months to a new record high. The 3-ma was the highest in more than three decades, suggesting housing could bottom during H1-2009.**



Source: National Association of Realtors and Bureau of Economic Analysis

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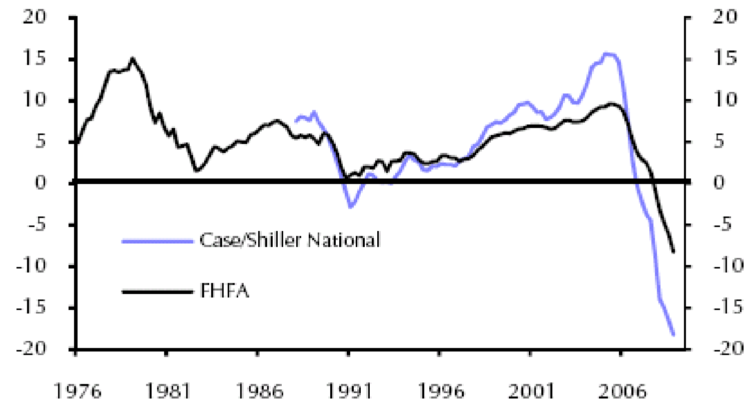
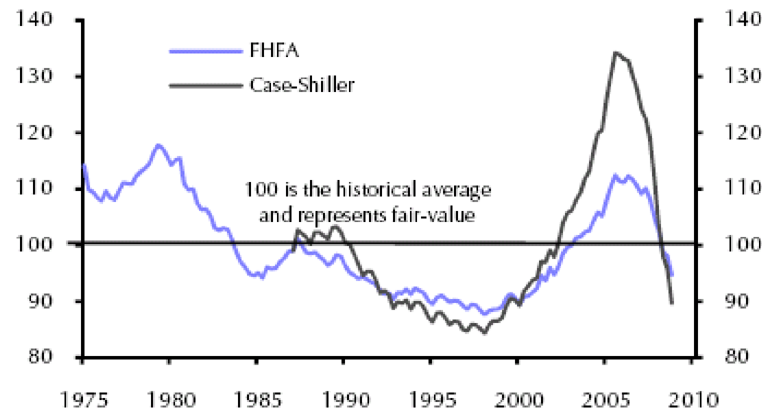
Not only is affordability high due to rates and income – houses are now below "fair" value.
Recent data suggests home prices as a multiple to disposable income (lower chart) will challenge the lows of the 90's – SOON.

CHART 1: HOUSE PRICES (%Y/Y)



Source – Thomson Datastream

CHART 3: HOUSE PRICES TO DISPOSABLE INCOME PER CAPITA



Source – Thomson Datastream

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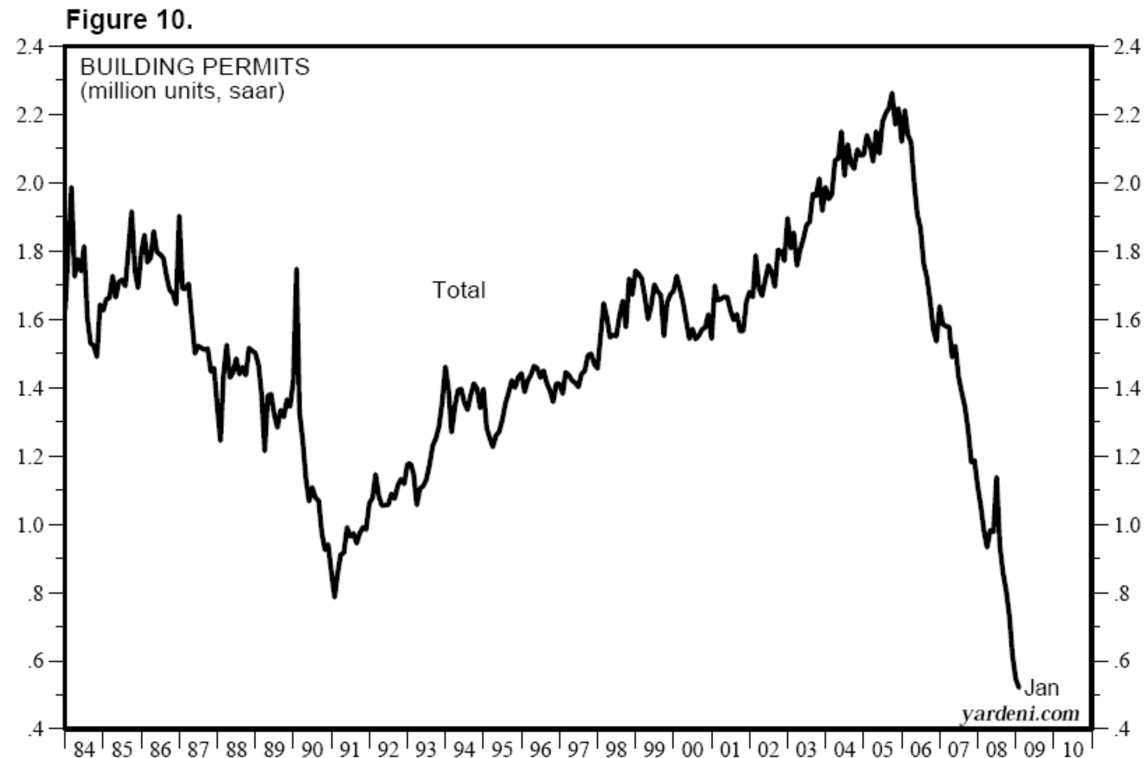
Current permits are at a level that is ~50% below the level needed to meet the natural demand for housing. We are entering the strongest seasonal period for home sales.



Any recovery in home values will have a leveraged positive impact on consumer sentiment. The conditions for an inflection point in home values are as visible and probable today as they were in hindsight at the top in 2005/2006.

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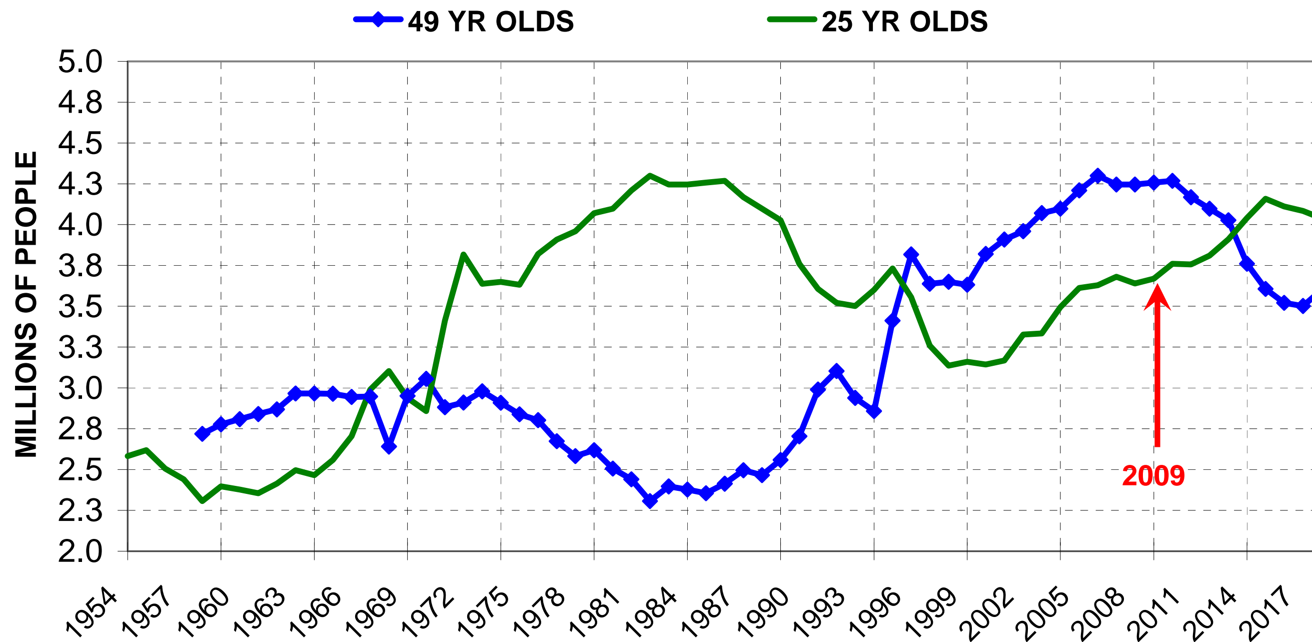
What About Consumer Spending? Can There Be a Recovery? . . . YES

The U.S. remains in a demographic "sweet spot" for productivity and consumer spending. The number of 49 year olds remains near peak levels and the number of Boomer children reaching the age of workforce participation and household formation is rising. Consumer spending is considered to peak at the age of 49.



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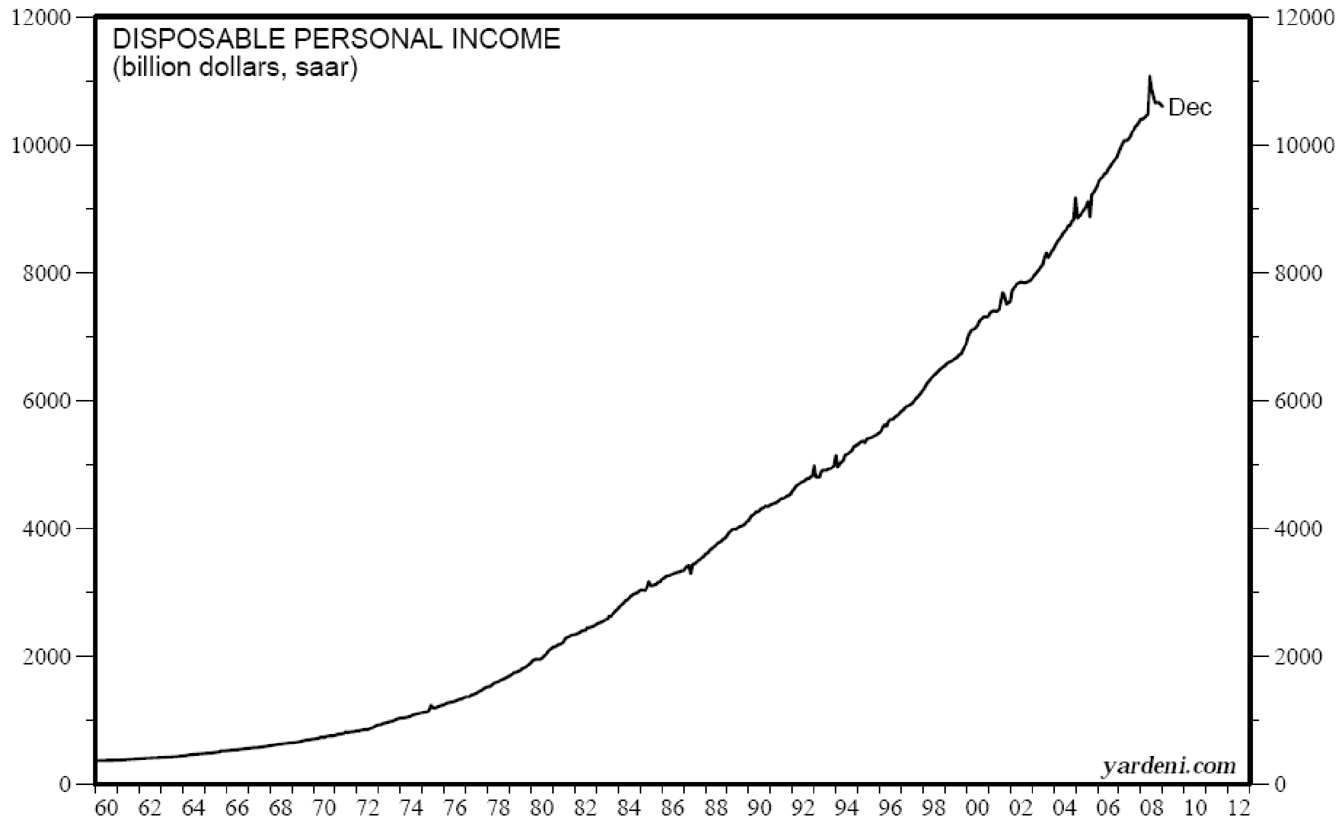
Consumer spending has not contracted so much from an incapacity to spend as it has from a collapse in willingness to spend – the panic impact. The headlines call for a retail Armageddon. But is the consumer really broke? I don't think so. Have a look at the chart on disposable personal income.



The point here is that $10.6 trillion of annual disposable income is not likely to materially decline for a prolonged period. We have the population. We have the productivity. And soon the capital market for asset backed debt used to finance consumer durable purchases will benefit from the new Fed facility – the "TALF" – Term Asset-Backed Loan Facility – being established to restore liquidity to that market segment.

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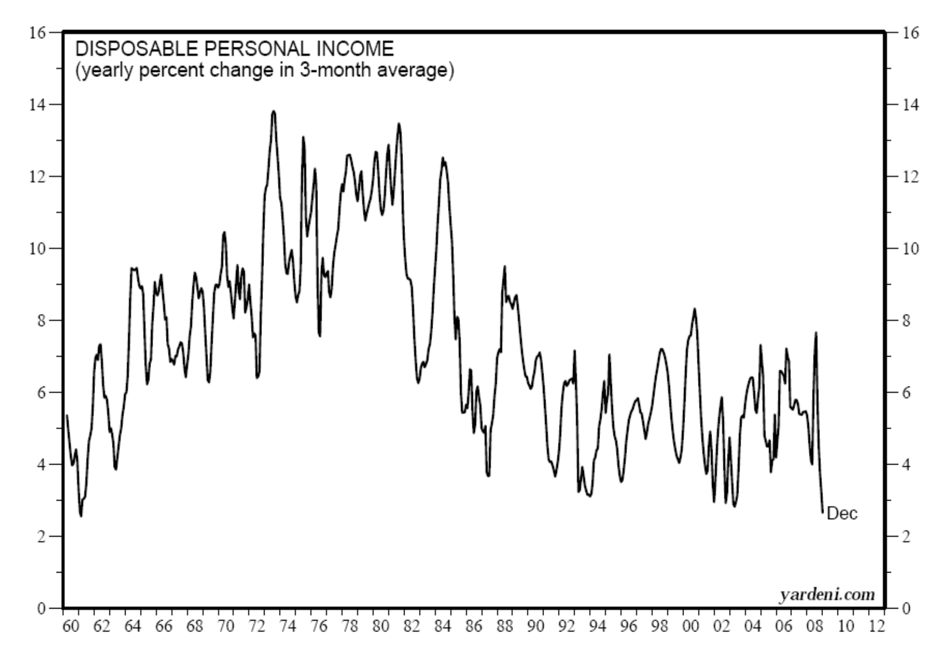
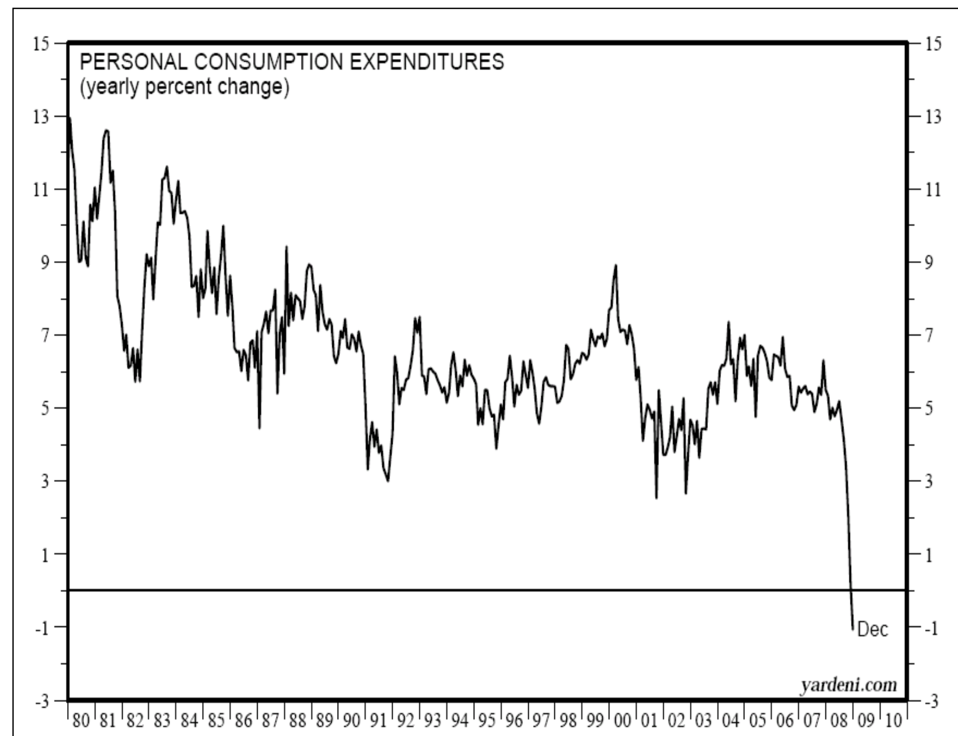
Drop in consumption far exceeds the drop in income => savings explodes upward.





(These charts, as are many in this report are courtesy of Yardeni & Co. I have positioned them to sync the scales.)

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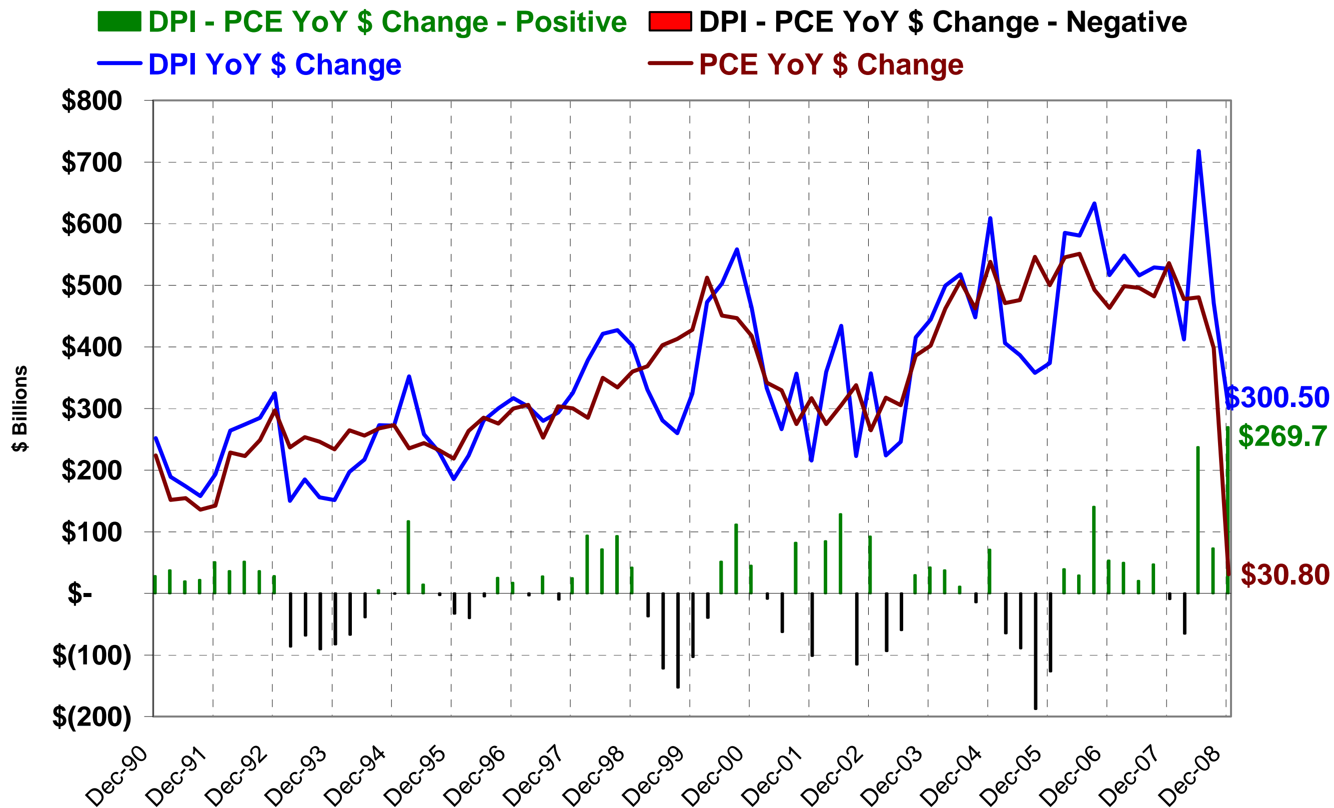
Never has so much money been saved so fast. Disposable Personal Income (DPI) grew $300 billion in 2008. Personal Consumption Expenditure (PCE) only grew $31 billion in 2008. Approximately $270 billion was stashed in checking accounts and money markets by consumers . . . and it is still growing. This chart is an annual rate of change. **Never has retail spending turned down so much or so fast. When sentiment shifts – and it will – consumer spending will rocket.**



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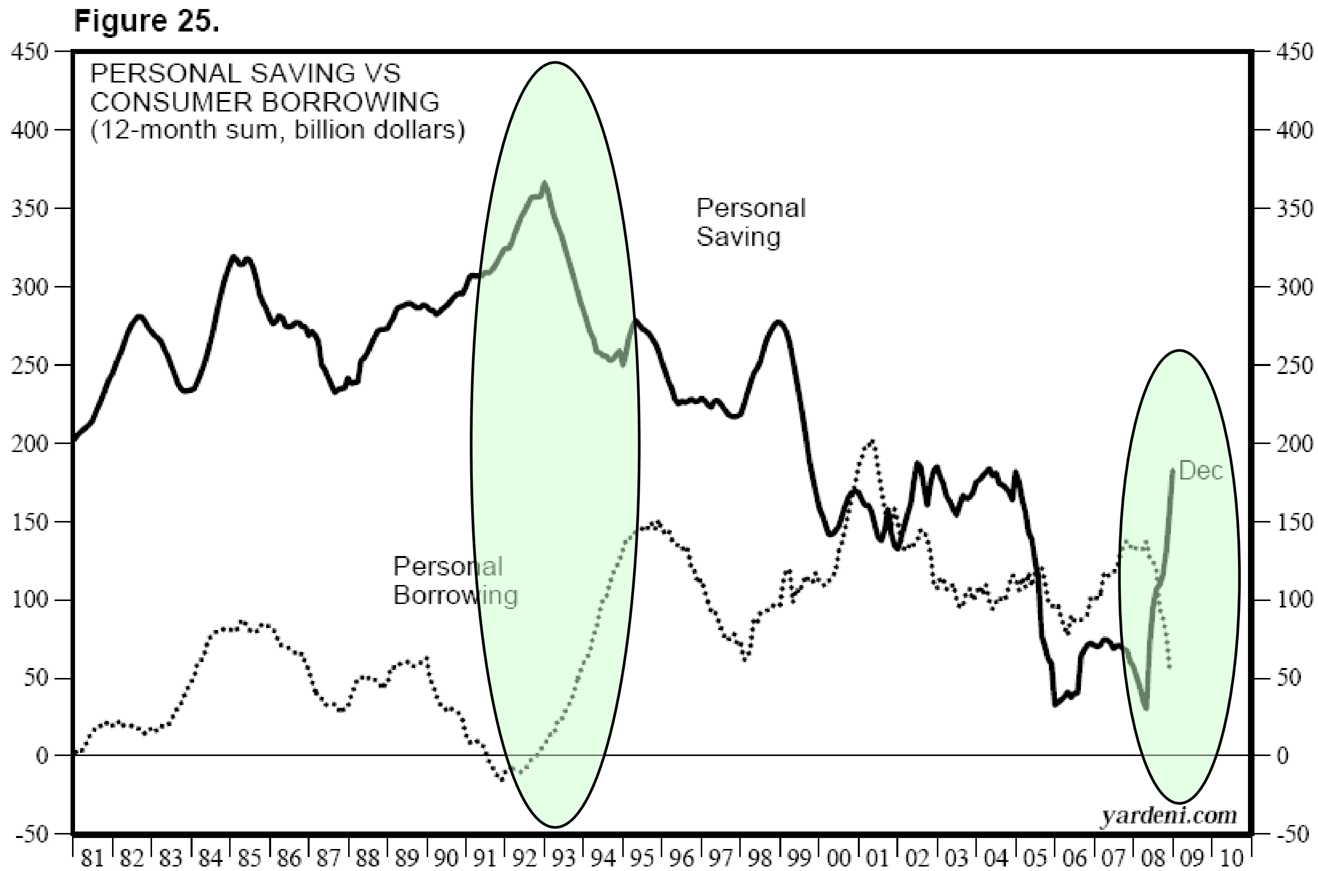
Saving more, spending less => borrowing less. There is ample capacity to spend – some day. If we experience a recovery such as occurred in 1992-1994 we would see a change in consumer spending that could be counted in the hundreds of billions of dollars.

Figure 25.



Source: US Department of Commerce, Bureau of Economic Analysis.

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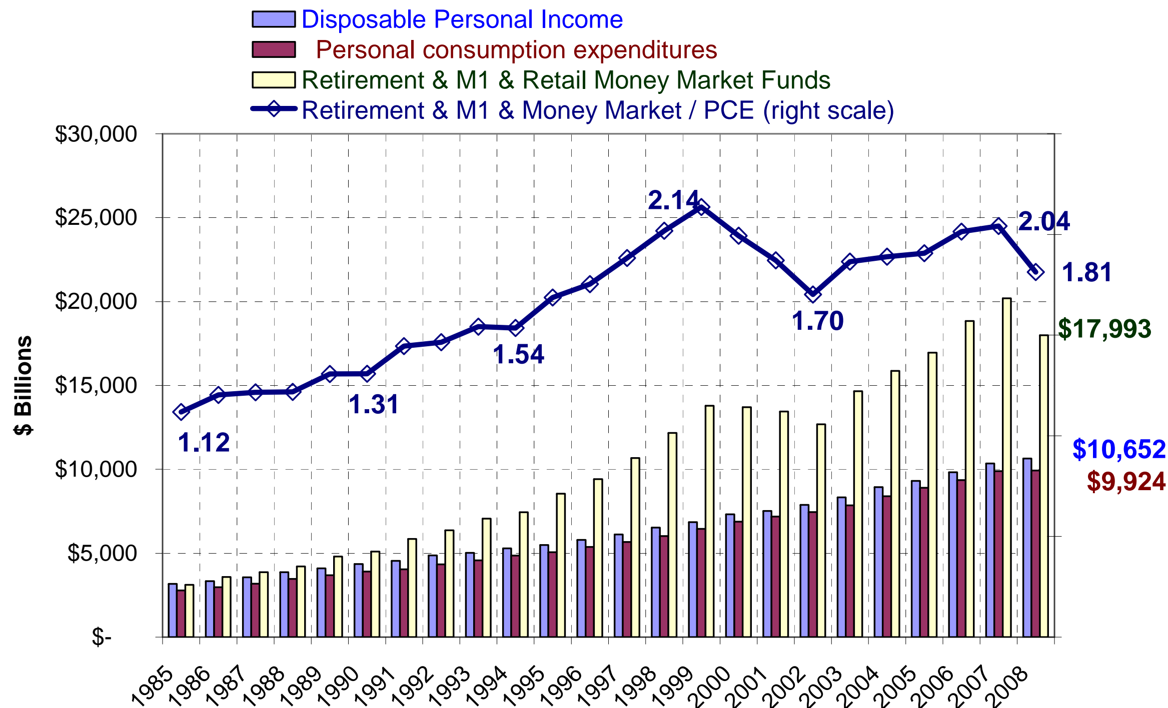
Savings are not as low as perceived at first glance . . . Some would argue that consumer spending will not recover until "savings" returns to early 1990's levels. It should be noted that "savings" as displayed in the above chart is the difference in disposable personal income and personal consumption expenditure. It is not an accumulated balance but is a "flow". An alternative view of savings is to consider the level of money in retirement accounts including IRA's, 401(k)'s and pension funds in addition to ready cash in checking accounts and retail money market funds. I have mapped out this "savings" view against disposable income and spending. (*I must warn you I have had to make an assumption about the drop in retirement account value as of year end. The metric has clearly worsened since year end)*. My goal is to point out the substantial financial assets and cash in the system relative to income and spending and how much those assets have grown . . . Americans are "investors" more so than "savers".



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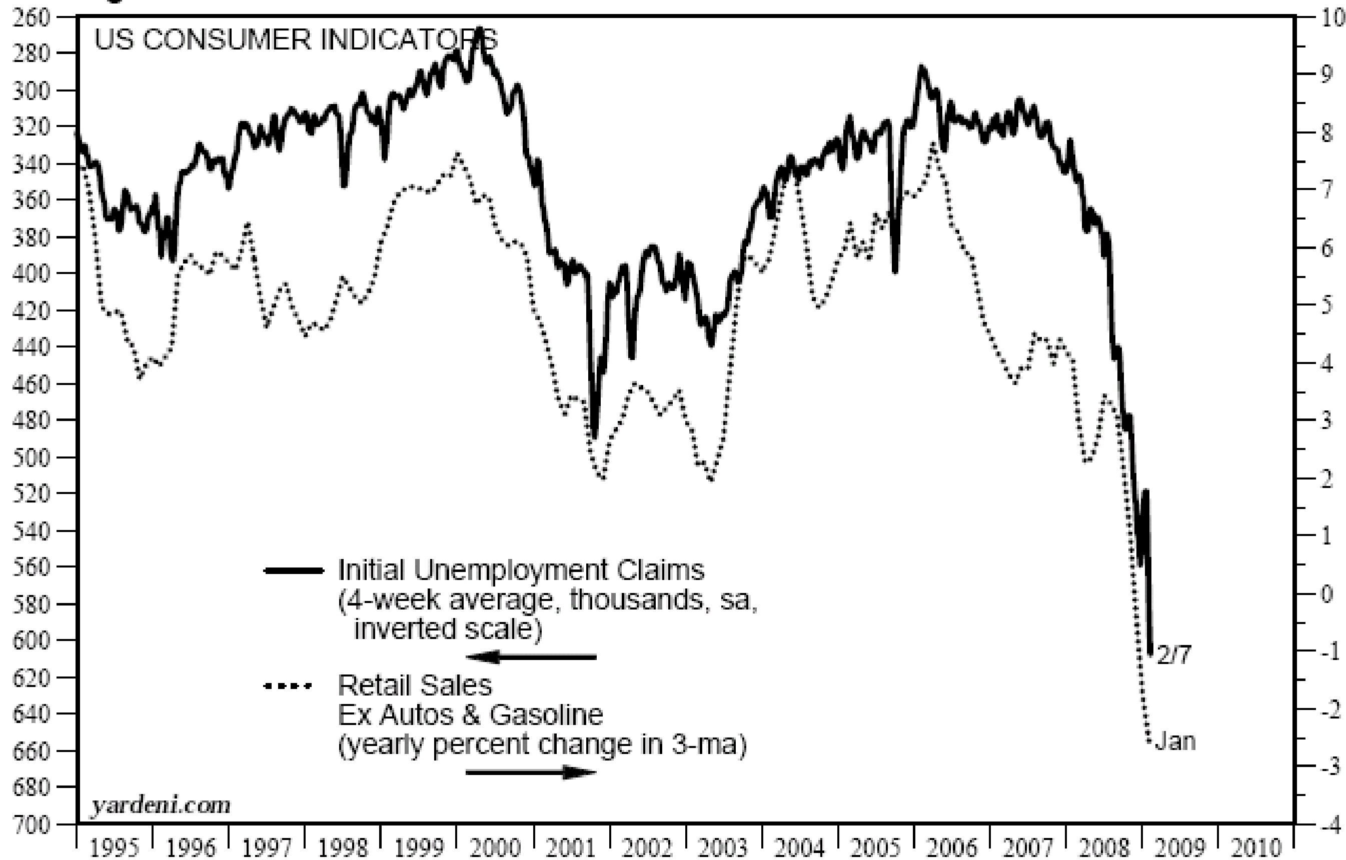
So . . . When exactly can we expect a recovery in consumer spending? How about when unemployment claims quit increasing – that's logical. The chart below illustrates that increasing unemployment claims have been certainly correlated if not causal of drops in retail sales . . . well DUH! Recall that the credit spread and the level of the New Order Index mentioned previously will help signal a turn to the better in employment and hence – lower unemployment claims.

Figure 77.



Source: Bureau of the Census and Bureau of Labor Statistics.

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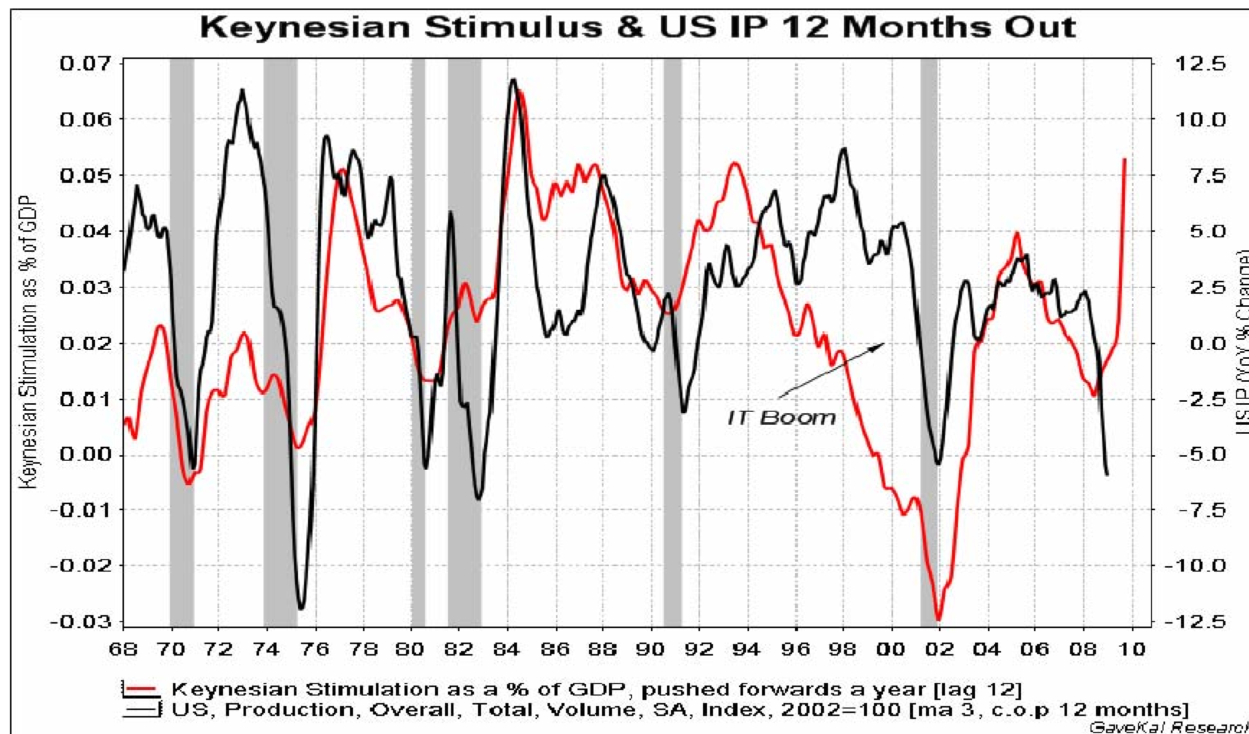
What Else Tells Us the Economy and Markets Are In Sight of Recovery?

The laws of economics have NOT been suspended. Markets and the economy do ultimately respond to monetary and fiscal stimulus and we are in a period where we are experiencing a record amount of both. The chart that follows from my friends at GaveKal illustrates the outlook for industrial production ("IP") in response to "Keynesian Stimulus" which they measure as the change in the percentage of government debt to GDP. The concept is straightforward. **As the government spends money, industrial production will respond**. The Obama administration just launched approximately $800 billion of government spending stimulus on a wide range of initiatives including internet infrastructure, alternative energy, healthcare technology and transportation infrastructure. We can debate the merits and demerits of the stimulus plan but the outcome will be the same



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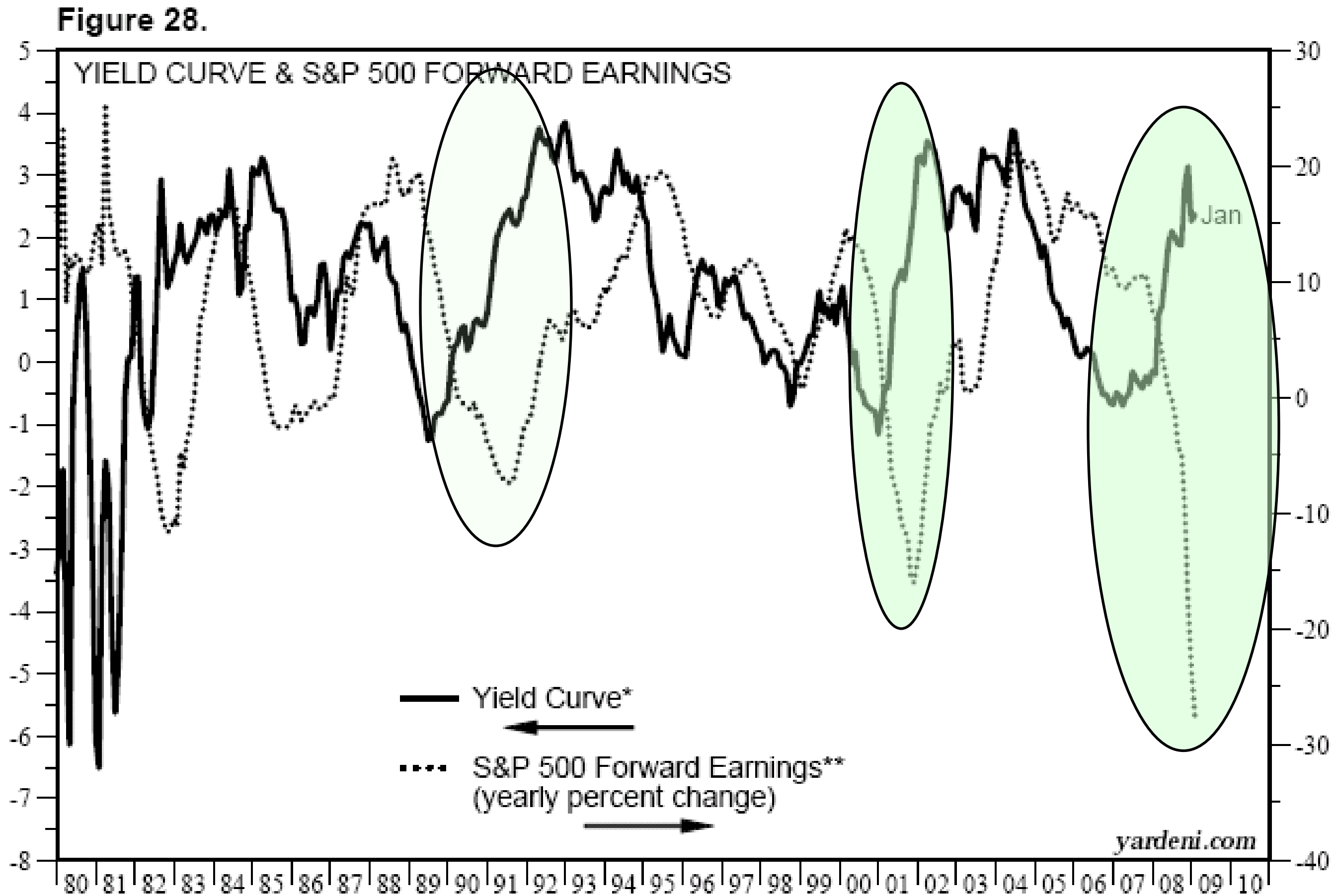
The yield curve also has been a leading indicator of the direction of corporate earnings. This chart shows that we are approaching a time frame when we may be able to expect earnings estimates to turn up.



* 10-year Treasury yield less fed funds rate.
** 12-month forward consensus expected S&P 500 operating earnings per share. Time-weighted average of current and next year's consensus earnings estimates.
Source: Board of Governors of the Federal Reserve System and Thomson Financial.

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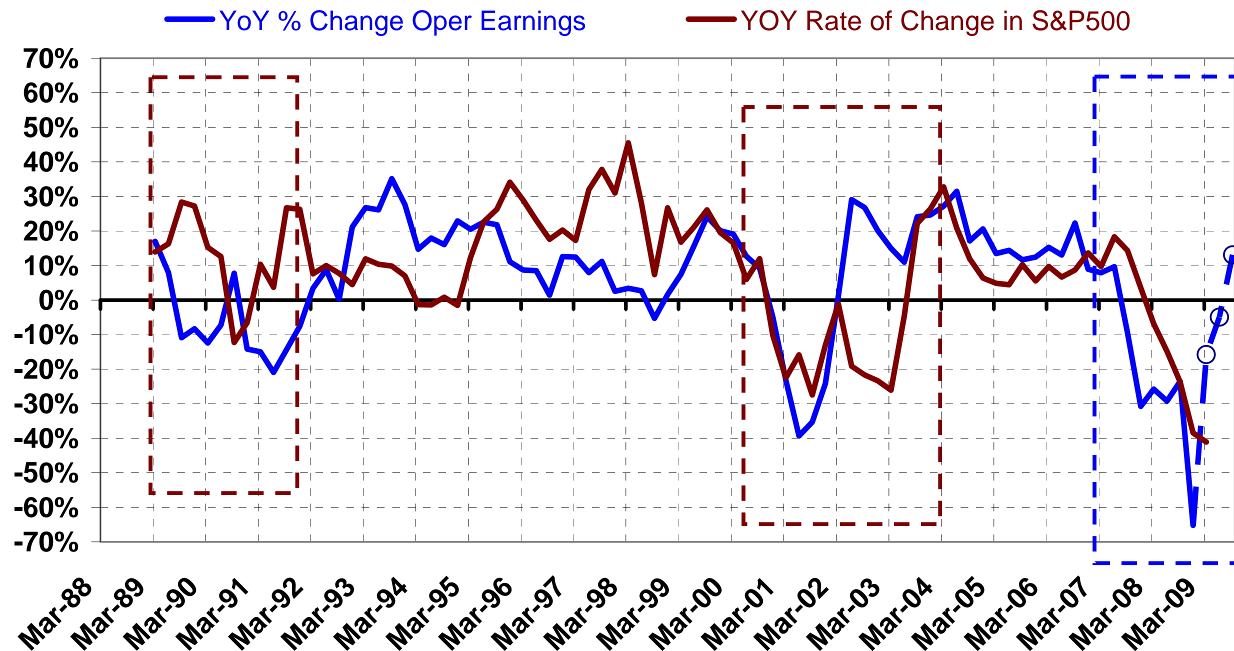
While debate will continue, the takeaway here is that operating earnings will begin to rise and will produce sharp year over year gains as we anniversary the abysmal results of 2008. That will begin to be discounted by the market and lay the predicate for rising stock values . . . just as in 1991 and 2003. We have to put some distance between us and the horrible Q4 results and all the write-offs to get people to start looking ahead instead of behind. You don't win races looking behind – eh?



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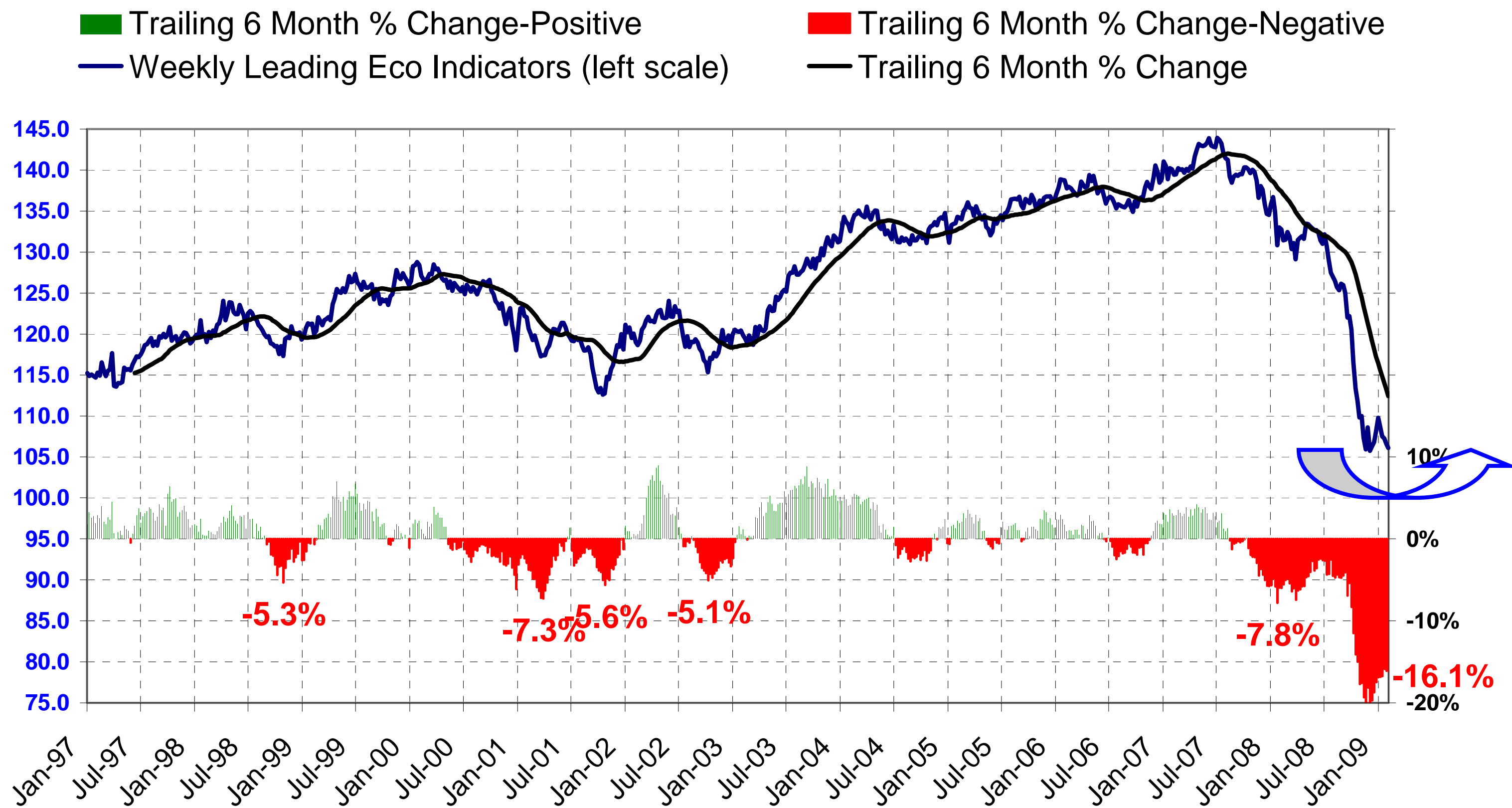
The economy's direction, as expressed by the **weekly leading economic indicators prepared by Economic Cycle Research Institute, appears to be making a bottom** adding yet another bit of evidence for a recovery in the economy and the stock market in the coming months.



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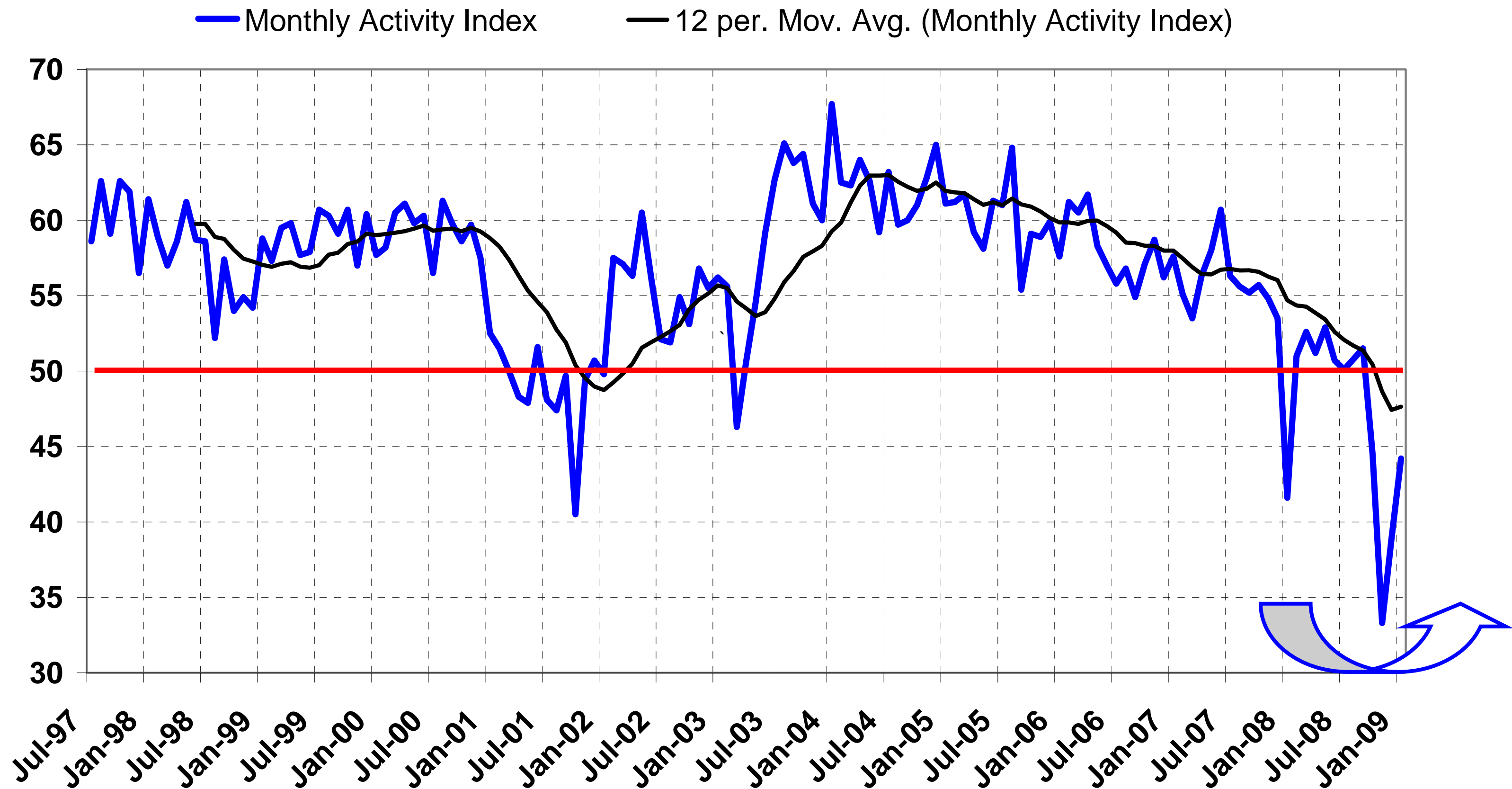
We can also point to the **nice recovery in the ISM non-manufacturing business activity index** as a precursor to a recovery. The bulk of the U.S. economy is now "non-manufacturing". (Manufacturing now only makes up less than 9.6% of the work force!)



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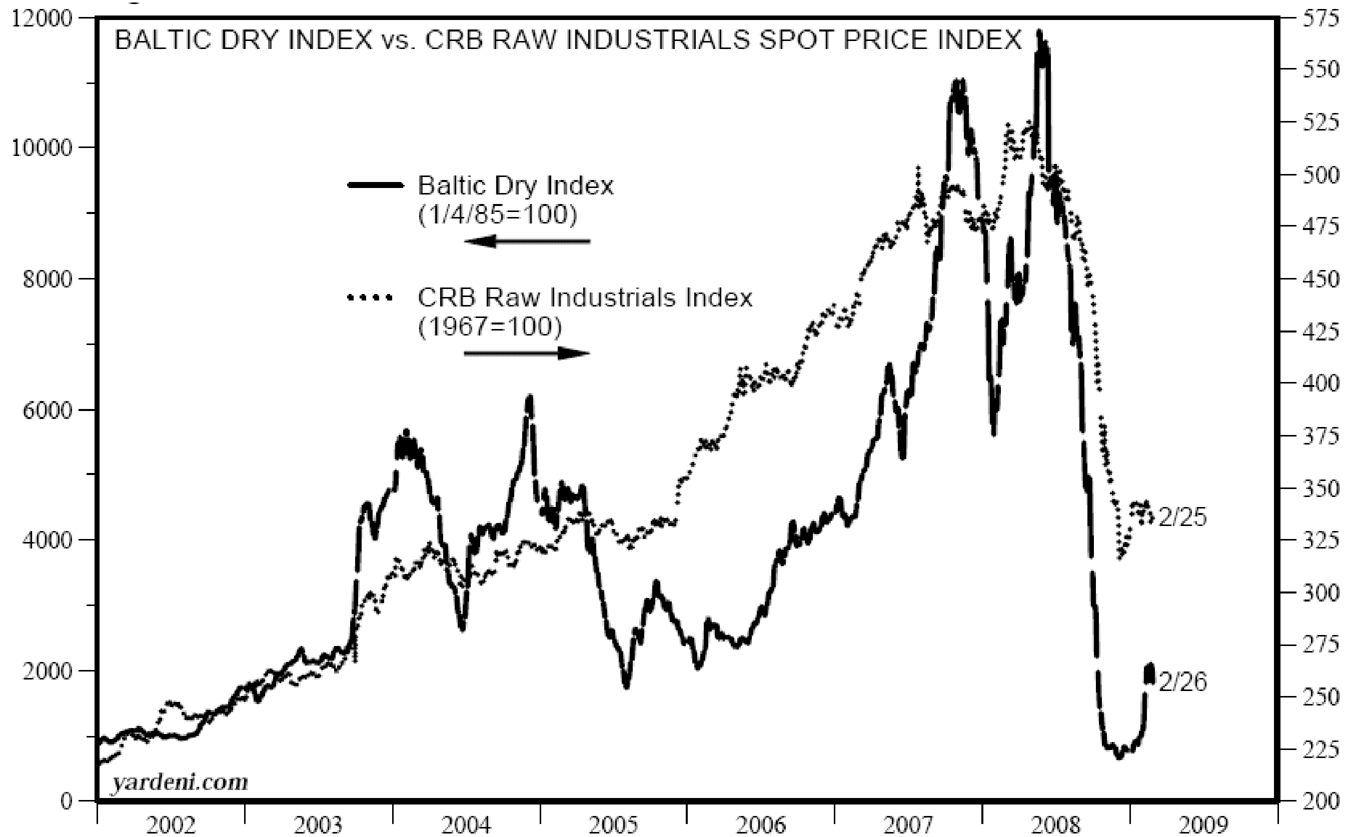
The level of global commerce may be also finding a bottom. The following chart of the Baltic Dry Index and the CRB Raw Materials index reveals a relatively sharp move off the lows. Increases in raw material prices and the cost of shipping them will be good evidence of returning global economic activity.



Source: Commodity Research Bureau, The Baltic Exchange, and Haver Analytics

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A Recovery Did Happen . . . Can 2009 Resemble 1933?

It has been noted that February was the worst month since 1933 if not the worst month on record depending on the index. There are some interesting similarities about 1933 and 2009.

1933			2009	
YTD Drop in Dow	-16%		YTD Drop in Dow	-20%
Democrat becomes President			Democrat becomes President	
FDR declares bank holiday			Obama launches Financial Stability Plan	
FDR lauches New Deal stimulus			Obama launches ARRA stimulus	
S&P 500 P/E Ratio	13.76		S&P 500 P/E Ratio	13.53
Annual Gain in Dow	67%		Annual Gain in Dow	?

There are many material differences today versus 1933. Can 2009 mark the bottom of the current recession and bear market as 1933 marked the bottom? . . . only time will tell for sure. I take comfort in the fact that our economy is much more diversified today.

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Recoveries Do Happen

I have presented this table in the past to illustrate the recuperative power of markets coming out of bear market lows. **One is handsomely rewarded if you are able to be invested at the bottom.**

BEAR MARKET RECOVERIES				
Date - Bear Low	1 QTR % PRICE CHANGE	2 QTR % PRICE CHANGE	3 QTR % PRICE CHANGE	1 YR % PRICE CHANGE
1929.4	17.2%	-4.6%	-13.3%	-28.5%
1932.2	**82.4%**	**55.5%**	**32.1%**	**146.3%**
1933.1	86.5%	68.0%	72.6%	83.8%
1934.3	4.4%	-3.2%	-13.7%	4.3%
1938.1	36.0%	44.0%	55.4%	29.2%
1939.2	19.9%	15.0%	12.8%	11.6%
1942.1	3.6%	10.5%	22.0%	44.6%
1947.3	1.3%	-0.2%	10.8%	2.5%
1949.2	10.0%	18.4%	22.1%	14.8%
1957.4	5.3%	13.1%	25.2%	18.0%
1960.3	8.6%	21.6%	20.8%	24.7%
1962.2	2.8%	15.3%	21.6%	-4.3%
1966.3	4.9%	17.8%	18.4%	26.3%
1970.2	15.8%	26.7%	37.9%	11.9%
1971.3	3.8%	9.0%	8.9%	12.4%
1974.3	**7.9%**	**31.2%**	**49.8%**	**32.0%**
1978.1	7.1%	14.9%	7.7%	13.9%
1980.1	11.9%	22.9%	33.0%	33.2%
1982.2	9.9%	28.3%	39.5%	36.6%
1984.2	8.4%	9.2%	17.9%	13.5%
1987.4	4.8%	10.7%	10.0%	-15.5%
1990.3	**7.9%**	**22.6%**	**21.3%**	**26.7%**
2002.3	**5.5%**	**4.0%**	**15.8%**	**22.2%**
2009.1	**?**	**?**	**?**	**?**
AVERAGE	**16%**	**20%**	**23%**	**24%**
MEDIAN	**8%**	**15%**	**21%**	**18%**
MAX	**87%**	**68%**	**73%**	**146%**
MIN	**1%**	**-5%**	**-14%**	**-29%**

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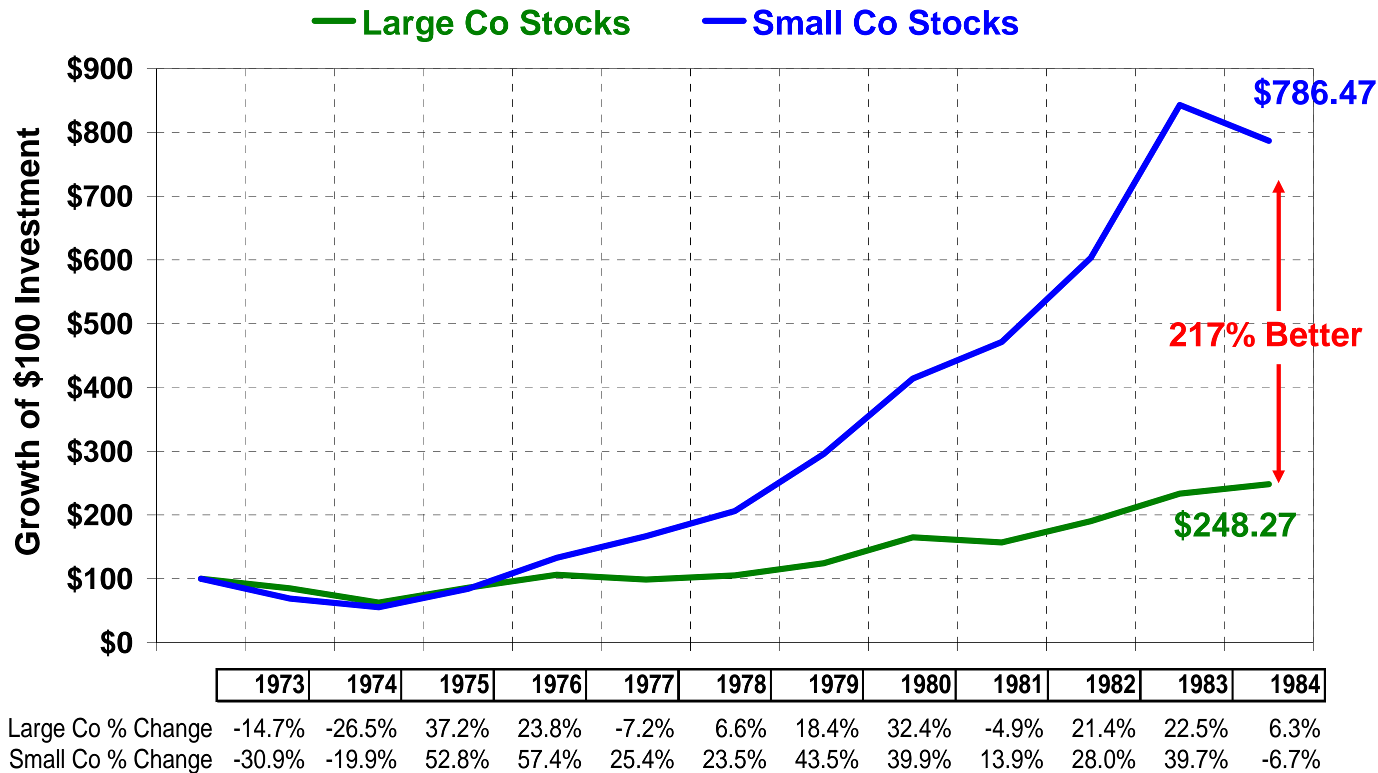
Where should you invest? . . . The bear market of the 1970's was the worst since the Depression. In the ensuing recovery, small company stocks far outperformed large company stocks. Small companies – such as those in the NASDAQ – appreciated by over 3X the amount that large companies – such as those in the S&P 500 – appreciated in the 10 years following the bear market low in 1974.



	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	1983	1984
Large Co % Change	-14.7%	-26.5%	37.2%	23.8%	-7.2%	6.6%	18.4%	32.4%	-4.9%	21.4%	22.5%	6.3%
Small Co % Change	-30.9%	-19.9%	52.8%	57.4%	25.4%	23.5%	43.5%	39.9%	13.9%	28.0%	39.7%	-6.7%

(Source data from Ibbotson Associates. "SMALL" in the above chart means stocks in the 5th capitalization quintile of stocks on the NYSE for years prior to 1981 and by the DFA Small Company Fund thereafter. "LARGE" means the S&P 500)

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So . . . Consider the following:

- **We are exiting a panic – NOT entering a Depression**
- The flight to cash is abating. Funds are beginning to flow back into the market led by buying of corporate bonds.
- The financial incentive to own equities is ENORMOUS
- Employment will remain weak as it lags the economy. Expect strengthening in Q3.
- Housing is approaching a bottom. Housing affordability has never been higher and affordability leads to more residential investment.
- Consumer spending can recover.
- There are multiple proven indicators supporting the case for a 2009 recovery
- Early phases of market recoveries produce handsome returns.
- Small company stocks should outperform large companies in the impending recovery.
- It's now time to mentally accept the notion of a recovery.

What to do?

- **Be Proactive** . . . Begin to invest NOW – of course, keep appropriate reserves.
- **Be confident** . . . I have armed you with information and context – you are the "smart money"
- **Buy Small Growth** . . . Our companies will outgrow the market.

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