

The Wile E. Coyote Stock Market

September 21, 2009

When I was a kid, I used to love watching Warner Brothers' *Roadrunner* cartoon. Perhaps you remember it...where Wile E. Coyote tried every scheme and contraption he could find to put Roadrunner on a dinner plate. Inevitably, Mr. Coyote would find himself running off some ledge and that's where "cartoon physics" would take over. Instead of immediately falling to his death, he'd just be hanging in midair, temporarily oblivious to the situation. But once he realized his predicament, then down he'd go.

We're in a Wile E. Coyote Stock Market. The laws of cartoon physics seem to have taken over the investment world and stock prices are "treading thin air."

For sure, global financial panic has subsided. And selected economic indicators seem to be pointing to slightly improving conditions (with caveats). But remember, simply because an economic factor is "less bad" doesn't mean it's good yet. And all improvements need to be weighed against any continuing problems.

The S&P500 index closed at 1,068 last Friday. That's a 60% rise from the March 2009 lows of 666 (though still down almost 32% from its high of 1,565 in October 2007). It's common to have strong snap-back rallies in the midst of longer-term bear markets. But this rally seems to be based largely on hope and hype with respect to economic expectations that I believe are unlikely to materialize.

David Rosenberg (formerly chief economist for Merrill Lynch, now with Gluskin Sheff) notes that, historically, by the time the stock market is up this much we're usually well into the third year of economic recovery.

Well we're a mere six months from the March stock market lows. And it's debatable whether we're even truly coming out of recession (or might dip back in), notwithstanding assertions by Federal Reserve Chairman Ben Bernanke and a consensus of economists. If we're crawling out of the hole, it's likely to only be a "technical" recovery with little to show for it, and it certainly won't feel like recovery to the average American.

When the stock market becomes totally unhinged from the underlying economy, I'm reminded of the words of John Maynard Keynes (1883-1946) whose pithy quotes I love, but economic views I hate. Keynes said:

"The market can stay irrational for longer than you can stay solvent."

So, just like Mr. Coyote in the cartoon, this Wile E. Coyote Stock Market could continue to "tread thin air" for some time, even though firm, sustainable economic ground lies far below.

Current US stock prices assume a rapid V-shaped economic recovery and have already priced-in a couple years of economic growth. Professors Carmen Reinhart and Kenneth Rogoff (who authored the study "Aftermath of Financial Crises") confirm that post-crisis downturns like the one we're in tend to be protracted. They resolve themselves over a matter of *years, not months.*

Since the stock market has gone “looney-tunes,” I’ve defensively positioned the portfolios of my discretionary advisory clients. Most are roughly 60%-80% in cash and short-term income investments. Though we generally performed orders of magnitude better than the stock markets in 2008, we’ve been lagging in 2009 since about April. But if I’m right—and recent stock market returns are not real or sustainable in the short-term—then we’re not lagging real economic value and should have our opportunity to buy back good equity investments at lower prices than today.

I sold some client equities when the S&P500 was around 850-860 in late April, which in hindsight turned out to be too early from a lost opportunity standpoint. More recently I sold equities when the S&P500 was around 1,000-1,020 to lock-in gains and preserve capital.

Bear market rallies should be “rented” not owned. So we’ll be content as spectators rather than participants as long as stock prices are this much out of whack vs. the underlying economic fundamentals.

I would rather lose clients who want to follow “the herd” than lose my clients’ money.

US Federal Reserve Chairman Ben Bernanke tells us the recession is over. Barry Ritholtz (author of *Bailout Nation* and owner of The Big Picture blog) asks why you should care what his forecasts are. Indeed. Bernanke apparently didn’t see this economic train wreck coming. He told us the sub-prime mortgage crisis was “contained.” Then he told us housing problems wouldn’t spill over into the broader economy. Etc. Sometimes it’s difficult to know whether our economic leaders are really the clueless dolts they appear to be or whether they’re just spinning the situation in order to keep confidence in the system going. But neither “idiot” nor “liar” are good choices, in my book.

What might keep the stock market rally going?

Global central banks have tipped their hand that they’ll likely keep short-term interest rates low for some time. They’re working hard on reflation to offset the deflationary forces in the global economy. And low short-term interest rates will both (1) permit the financial sector to continue earning ungodly profits on their nominal cost of money, and (2) tend to stoke the fires of stock market levels, particularly for those who are predisposed to believing the recovery hype.

It’s looking like Gross Domestic Product (GDP) will likely be positive for Q3-2009. Assuming it is, expect our government and the financial media to blow a trumpet over the (alleged) recovery. But it will probably only be a “technical” recovery at best. It’s common during recessions/depressions to have quarters with positive growth. At best, it’ll be the start of a very slow, muddle-through growth—and won’t feel like growth to most Americans. And let’s not forget...whatever recovery there is is extremely fragile. We might end up in a double-dip recession.

Why am I so sour on the likelihood of a sustainable near-term economic recovery and so skeptical of current stock market levels? Believe me, it’s not because I like it. It’s a whole lot more fun to be a bearer of good tidings. And it’s just plain hard work—emotionally

and intellectually—to engage in critical thinking, examine research, and then buck the herd. So here’s a long (but non-exhaustive) list of issues that seem to more than offset the nominally positive economic data of the last few months.

You’re forgiven if you choose not to plow through this litany of economic issues and problems. But just understand there’s a lot of “bad stuff” which either hasn’t been dealt with, is still coming, or isn’t getting the attention it warrants.

- This was not an ordinary downturn in the business cycle, not a run-of-the-mill recession. It was an asset price and credit destruction tsunami. Consequently, we can’t look to previous “normal” recessions for guidance on how this might unfold. We have to include eras such as the US Great Depression of the 1930s and Japan over the last 10-15 years—where asset price deflation and credit destruction were significant issues. And, of course, we also have to consider what’s different now.
- Those who are looking for a rapid V-shaped economic recovery either don’t understand the present economic crisis or are simply talking-up what would be in their own best interests.
- Unemployment is high and likely to continue rising for several months. Headline US unemployment (U-3) was 9.7% nationally in August. A perhaps more accurate measure of unemployment is the U-6 rate of 16.8%--which includes workers who’ve been downsized to part-time though they want full-time work, unemployed people who’ve become discouraged and quit looking for a job, etc. Our government and the media typically headline the U-3 number, but the higher U-6 number is how the present situation feels to the average American.
- Average hours per week worked have fallen to around 33. When economic growth picks back up, where do you think labor is going to grow first? Businesses are going to increase the hours per week of their existing workforce before they hire new employees. This will further delay any decline in the unemployment rate.
- The Birth-Death Adjustment formula has been a complete and utter joke for the last couple of years. That doesn’t refer to births and deaths of people. Rather it’s part of a formula used by the US Bureau of Labor Statistics (BLS) to estimate the number of new businesses created as well as businesses closing during the time the BLS takes the monthly employment survey. The Birth-Death Adjustment is notorious for being a terrible estimate at turning points in the economy. During recoveries, it tends to underestimate the number of jobs being created. But during recessions, it overstates jobs. And during this prolonged contraction, it has grossly overstated the number of jobs being created. For example, from February through August 2009, the BLS Birth-Death Adjustment shows more than 1 million net new jobs having been created. Aside from government, where pray tell do they think new jobs are really being created in this environment? The real unemployment rate is higher, except the Birth-Death Adjustment joke has inadvertently made things look better than they are.
- Unemployment claims are high. While new and continuing unemployment claims get reported, there’s little to no reporting on unemployment benefits exhaustion. That’s the growing number of folks who’ve used up all of their (extended) unemployment benefits. But they don’t get captured in the data because they’ve fallen off the unemployment rolls. Be wary and think critically when you hear reports that new or

continuing unemployment claims are falling. Remember it's what's not seen or reported that can be the bigger issue.

- Home foreclosures are still rising. Foreclosure moratoriums had given the impression for a while that things were improving. Mortgage modification programs have been largely ineffective vs. all the hope and hype. Mortgages modified in 2008 have experienced delinquency relapse rates of around 50% by 12 months later. While some folks have unfortunately lost their job or got hit with major medical expenses, the reality is a lot of delinquent folks should never have been given a mortgage in the first place. Modification of the mortgage terms will change little in such instances.
- We're pretty much through the sub-prime mortgage crisis. But now we see on the horizon a second tidal wave of potential defaults (starting in 2010) with respect to prime borrowers whose adjustable rate mortgages (ARMs) are about to reset. This is likely to further glut the housing market, applying further downward pressure to home prices.
- And while the howls of protest over bad lending standards seem to be fading, the FHA has recently been financing about 40% of all new mortgage originations. How are they doing it? With loan programs that require only 3.5% down with 96.5% being financed. Wait a minute! Didn't we just go through this? Didn't we just determine that borrowers are far more likely to default when they have little to no "skin in the game?" Obviously we didn't learn a thing: "damn the torpedoes, full steam ahead!"
- Though we can't really quantify it, there's a host of anecdotal evidence confirming that speculators have been buying foreclosures through the recent decline. Many had no idea prices would continue falling as they have (and probably will yet). A lot of these buyers have no intention of living in the home(s) they purchased. But they don't want to try to sell the home at current prices. What this means is there's a "shadow inventory" just sitting and waiting to be put back on the market when prices are more acceptable. But this additional supply will likely have a dampening effect on any stabilization and recovery in home prices.
- Credit card delinquencies are rising. Bank of America recently reported that its charge-off rate rose to 14.5% in August from 13.2% in July. Citigroup's rate increased to 12.1% from 10%. And Discover Card delinquencies increased to 9.1% from 8.4%. It's getting worse, not better.
- The US consumer has been responsible for roughly 70% of our economic growth in recent years (largely through borrowing and spending). Now we have increasing job losses, delinquencies, foreclosures, bankruptcies, and credit contraction. Social mood is changing. "Frugality" is starting to come into vogue again. Consumers are beginning to focus on smart shopping tactics. And we're trying to pay down our debt (though we have miles to go). Paying off debt is great at the individual level. But it wreaks havoc on a broader credit-based economy. It should come as no surprise then why global central banks are hell-bent on artificially propping-up asset prices and trying to reflate the economy through additional borrowing.

So in light of these developments, where's the growth going to occur? What's going to sustainably pull the US out of recession? Business investment spending? Exports? The rest of the world is being negatively impacted by the decline in our

consumptive behavior. It's likely to be a muddle-through economic recovery in fits and starts, and a stock market with manic depressive mood swings.

The problem is almost nobody is speaking the cold, unvarnished truth that the only real solution to these problems is we now have some strong medicine to take and the true path to sustainable recovery will be painful while we work off the excesses. Anything else—denial, artificial reflation attempts, more borrowing—just kicks the can further down the road.

- The recent “positive” development in retail sales and housing was largely due to the Cash for Clunkers program and the \$8,000 first-time homebuyers credit, along with various other government stimulus programs. But all that's been done is to artificially pull future demand for autos and housing into the present through means funded by the taxpayer (or more accurately, funded by China buying our bonds which will be paid off by our grandchildren's taxes or frittered away through a declining US\$).

So we have a temporary “pop” which has the appearance of a jump-start in economic activity. But the programs are over (at least Clunkers is, congress is considering extension of homebuyers). So what rabbit are they going to pull out of the hat now? More to the point, why should government be feeding steroids to the auto and housing industries in the first place? (That was a rhetorical question, in case you're wondering.)

- A number of businesses have been beating profit estimates lately. What goes largely unreported though is they're beating *low-balled, revised* estimates vs. the forecasts of earlier this year. And they've hit the targets largely through one-time cost-cutting measures, a lot of it through reduction in workforce. Of course, that hits the consumer, which hits spending, which hits our US economy, and so goes the vicious circle. So businesses have been meeting their targets through these one-time cost reductions. What are they going to do for an encore? Year-over-year top-line revenues are *way down*. They're going to need improvement in revenues to get back to financial health.
- Corporate insiders (management, directors) are aggressively selling their company stock. Recent ratios were around \$30 sold for every \$1 bought. Is there maybe something they know about the economy and the prospects of the companies they run that the broader investment and economic community seems to be missing?
- Commercial real estate is probably the next major shoe to drop. I could spend the whole letter on this topic alone, so let's not get too deep into that. Suffice it to say the default rate on commercial real estate loans has spiked, is increasing, and there are hundreds of billions of dollars in loans coming due with no readily-available refinancing in place. Defaults in this sector will almost certainly hammer small and mid-sized banks with large write-offs—and most likely contribute to bank failures.
- Banks have been subsidized at phenomenally low interest rates so they can try to earn their way out of this situation. These are not real profits earned on the real business of banking, but artificially subsidized profits since their “cost of money” is so low. And a significant portion of the recent earnings of the big banks has been related to trading, not standard banking. Lending has actually declined, though reserves are way up.

- The “Bank stress tests” conducted earlier this year were non-stress tests. They were an analytical joke but a great PR move by the government and, as such, largely accomplished their goal of restoring some level of confidence (however misplaced) and enabled banks to raise more equity capital at higher prices. But it’s no measure of the true situation. In fact, economic developments have *already* gotten worse than some of the government’s “adverse scenario” estimates.
- Earlier this year, market-to-market (MTM) accounting rules were suspended. In a nutshell, MTM required institutions to record their investments at each quarter-end using values at which they could sell to a willing, uncoerced buyer. Admittedly, some of the investments are not traded regularly and are difficult to value. But the suspension of MTM has allowed companies to engage in “mark-to-fantasy” rather than recording investments at their true value and taking the corresponding write-downs for amounts they’re almost certainly never going to collect. Consequently, financial statements of the financial/banking industry are suspect because their true financial condition is considerably worse than portrayed.
- There have been 94 bank failures through last Friday. Institutional Risk Analytics (IRA)—the recognized bank analysis gurus in the industry—gives 2,256 banks an “F” grade using IRA’s own Bank Stress Index, not the government’s fake test. The Federal Deposit Insurance Commission (FDIC) has a little over 400 banks on its current “watch” list, but IRA estimates that 1,000+ banks will either fold or be taken over in this cycle.
- With the failure of Bear Stearns, Lehman Brothers, Washington Mutual, Wachovia, and near failure of Merrill Lynch and AIG, the government stepped in and basically indicated that—due to “systemic risk” (risk that a large enough institutional failure could bring down the entire system)—there were some institutions that are basically too big *to be allowed* to fail. That was a year ago.

So what’s been done to modify regulation or foster an environment conducive to reducing the prospect that one institution could bring down everybody else? Nothing. In fact, it’s moved in the opposite direction. Maybe leverage levels are coming down some. But now we have Bank of AmeriCountryLynchica and other such Frankensteins, larger than before. We may well be simply setting the stage for bigger systemic risk issues in the future. And given the government’s stance this last time around on “too big to fail,” how will they use taxpayers to backstop a monumentally larger economic catastrophe.

- It’s been “junk” stocks that have rallied the most recently. Get this: reportedly about 40% of recent trading volume in US markets was due to *just four stocks*: Bank of America (BAC), Citigroup (C), Fannie Mae (FNM), and Freddie Mac (FRE). These are firms essentially on government life support. And the S&P500 companies with the worst unfunded pension obligations are up about 200% in this recent rally.
- Bank of America analysts recently estimated that about 40% of all US junk bonds (bonds rated lower than investment grade) outstanding in late 2008 are likely to default by 2013. That compares with a default high of around 30% in prior recessions.

- Price-to-earnings (PE) ratios—one of the most commonly used measures of stock market values—are currently very high. The S&P500 had a recent PE of 26.5 when compared with trailing 12 month operating earnings of companies in the index. That PE jumps to 180+ when using trailing 12 month reported earnings. “Reported earnings” include all that one-time write-off of bad stuff—you know, like loans gone bad, restructuring charges due to layoffs, etc. The trouble is, for a lot of companies those one-time write-offs are happening about every quarter. Never mind.

The average S&P500 PE ratio over long periods—through thick and thin—is about 15. At the end of long-term bear markets just as a long-term bull market is starting, it’s not uncommon for the PE ratio to be around 8-10. See why I’m concerned about the Wile E. Coyote stock market and about protecting client capital from a pullback?

- So the economy is like a patient on the operating table and our dear government keeps giving it stimulus steroids. It’s totally beyond me why the “economic brains” of this country seem to think the way to resolve our economic problems is to feed them more of the very thing that got us here in the first place. Kind of like giving the drunken sailor another shot of scotch.

And this begs the question: How is the US Federal Reserve and US government going to extricate itself from the slough of unprecedented credit easing and stimulus programs that they’ve created?

- Sales tax, income tax, and other tax revenues are way down over the last 12-16 months. States, cities, and counties are getting hammered budgetarily. This translates (or at least should) to reduced services, job cuts, etc.
- We’re beginning to see, perhaps, the early stages of trade protectionism cropping up. Since the global recession started, there have been several such measures between countries, but the latest getting quite a bit of coverage is the US tariff on tires imported from China. It will be interesting to see if/how these issues escalate and the impact on dragging out a global recovery.
- Some forecasters are predicting China and/or other countries are going to pull the globe out of recession. No doubt, some countries aren’t facing the same economic/banking issues we are. On the other hand, some are worse off (think Britain). There’s a considerable case that the European banking system is worse off than ours—due primarily to higher levels of leverage and exposure to bad loans in Iceland, the Baltics, and other Eastern European states.

But let’s not necessarily look to China to be the savior of the world. Their economic numbers don’t all add up like so. It appears they “cook their books” some. For one thing, they account for economic matters differently than we do. We measure Gross Domestic Product (GDP) when we see economic results working through the economy. China measures its “GDP” when the government issues an edict on lending and makes the money available to banks (that’s oversimplified, but you get the picture). Who knows what real economic impact that money had (or didn’t)?

- Finally, when global economies and markets are so fragile to begin with, it doesn’t take much of a natural disaster, infectious disease epidemic, or political instability/war to knock things off the rails again.

It won't be this way forever. There will be times when we can be optimistic again about the economy and markets as a whole, or situations where the manic-depressive market presents us with opportunities to snap-up individual investments or sectors at bargain prices. But I don't think that time is now.

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