

Market Outlook

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Collective Amnesia

As the economy has haltingly improved and stock prices have steadily risen since last autumn, policy makers and investors seem to have adopted an air of collective amnesia about them. Amnesia seems to be the only explanation for the unwillingness to deal with the myriad problems we face in the wake of the bursting credit bubble, coupled with a naïve faith that somehow a normal recovery is right around the corner. Bill Gross of PIMCO coined the phrase “the new normal” to describe the subpar and anemic growth that ensued in the aftermath of previously burst credit bubbles. As both lenders and borrowers retrench and rebuild their net worth, this is exactly what we are experiencing today. Unemployment remains stubbornly high, consumer spending seems tentative, and the continuing fall in home prices provides powerful resistance to returning to the “old normal” of traditional recoveries.

The primary amnesiac in the financial markets today is Federal

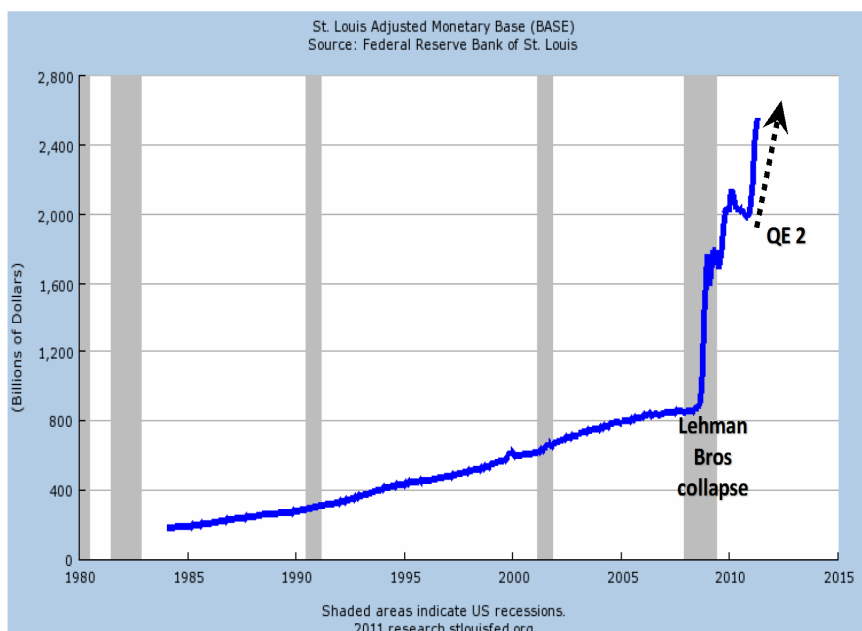
Reserve chairman Ben Bernanke. After stepping in as “lender of last resort” to stave off widespread bankruptcies among banks in 2008-09, the Fed has attempted to stimulate the economy using “quantitative easing” (QE) tactics, as they can get interest rates no lower. Dating back to the days of Alan Greenspan’s reign at the Fed, almost every financial crisis has been met with a flood of liquidity into the banking system, historically generating

a Pavlovian response of increased borrowing among consumers, builders, and investors with every decline in interest rates. This “easy money” policy helped fuel speculation in real estate and stocks, only to end in tears in 2008.

Today, monetary policy is as easy as it has ever been, and yet the economy is improving only slowly. The chart above shows the Adjusted Monetary Base, which reflects the tremendous flood of money into the banking system. The scale of today’s increases in the Base dwarfs any previous stimulus, including the small blip around 2000 as banks were made flush with cash in anticipation of Y2K problems. While the Main Street economy has feebly

recovered, the financial economy (i.e. Wall Street) has been on a tear since the second QE program (QE2) was announced last October. QE2 had several goals, including lowering long-term interest rates, driving down the value of the dollar and increasing inflation in consumer goods and asset prices (most importantly housing). While somewhat successful on this score, they have been *very* successful in driving up stock prices, hoping to make people feel the “wealth effect” from their rising portfolios and encouraging them to spend more.

But QE2 has always had the potential to create another speculative bubble in stocks. Bernanke is suffering from amnesia in that he seems oblivious to the Fed’s role as “enabler” of the speculative bubbles of the last 15 years. The Fed has made it very clear that QE2 will end in June 2011, and it will be interesting to see whether a stock market that has become addicted to liquidity in the last two years can wean itself off without major accidents.



The late Milton Friedman must be shaking his head as he watches us from his celestial ivory tower. Friedman was the 20th century’s preeminent “monetarist” economist, who believed that the supply of money in an economy (and its “easy” and “tight” oscillations) caused most of the problems of the business cycle. To monetarists an easy money policy, as we have now, is a harbinger of inflation down the road, as “too much money chases too few goods” and easy credit fuels consumption and

spending. Is the Fed falling behind the curve in controlling inflation? Currently, banks are reluctant to lend and, unlike past recoveries, consumers don’t want to add even more debt to their balance sheets. Thus, the demand side of the inflation question is tepid at best. Weak business recoveries and rising money supply have the potential to create stagflation, the bane of the 1970s recessions. While official inflation, the Consumer Price Index (CPI), is tame, inflation on Main Street is becoming more pervasive. Producer price indices, which often don’t get headlines in the popular press, are rising at 5-10% annualized rates now. Should oil prices stay high, the effect on the CPI would start to become worrisome in the next few months.

However, inflationary psychology has not taken hold as yet. We have become conditioned to low inflation, as past bouts of price pressure have proved fleeting. Even Bernanke described energy price inflation as “transitory,” echoing past Fed chairs that ignored inflationary clues until too late, only to be forced to abruptly change course on monetary policy. Given today’s very easy monetary world, *any* change may be viewed as too abrupt by a market accustomed to nearly free money.

The festering debt problems in Europe are another sign of collective amnesia. After proposing an enormous back-stop of Greek debt in 2010, the “shock and awe” that the International Monetary Fund (IMF) and European Central Bank (ECB) had hoped would restore confidence has foundered on the rocks of Greece’s inability to implement the draconian austerity measures it promised last year. Banks, hedge funds, and government owners of Greek bonds who didn’t bail out early are now stuck, unable to sell the depressed debt or buy default insurance on it at a reasonable price. They are hoping that time, and central banks, shore up the dicey debt of Greece, Portugal and Ireland so they don’t have to realize what could be significant losses in the event of a “restructuring” (change in loan terms to lenders’ disadvantage). This is eerily reminiscent of the early stages of the sub-prime mortgage market collapse in 2007-08, as policymakers insisted sub-prime problems were contained, only to be blindsided by the extent of the losses throughout the banking system. Just like then, the problem is failing to see the Greek dilemma as one of *solvency*, not liquidity. Illiquidity is when a borrower has short-term cash shortages that hamper its ability to pay on time. Insolvency means debt has overwhelmed assets, and the entity is unable to pay back the loan at any cost. Sub-prime borrowers became insolvent as they lost their jobs; Greece is precariously close to the same situation as its economy shrinks and citizens rebel against further austerity measures. Yields on Greek government debt have soared to 16% as investors bet that the amnesia demonstrated by the IMF and ECB will have a bad outcome.

While stock investors have enjoyed a very persistent rally since late 2010, they too run the risk of being lulled into a sense of amnesia. Improved corporate earnings and sales have been dealt a blow by the Japanese earthquake and the rise in oil prices. The former has caused a disruption in the supply chain for many goods that depend on Japanese technology. The Arab Spring uprisings and civil war in Libya have caused oil prices to rise

by 40% since January, significantly raising the costs of production. Increasingly, companies are citing increased costs, rather than weak demand, as reasons they are not meeting Wall Street’s earnings forecasts.

We think the financial markets may have become addicted to easy money, and as the chart on page 1 shows, it doesn’t get any easier than this. But it clearly cannot continue at this pace, and the Fed has promised as much. It is *possible* for there to be a QE 3, but the odds are heavily against it as the Republicans in Congress would call for Bernanke’s head on a platter in such an event. So Wall Street is going to have to get used to not having a liquidity tailwind for the remainder of 2011.

The message from the market is one of rather high risk, and where long-term measures of breadth are turning down from tops. Chief among these are the “Bullish %” charts produced by Investors Intelligence. These slow-moving indicators measure the percentage of stocks in an index/sector that are on buy signals using point-and-figure charts. In its own way, it measures the true demand for stocks, since rising prices (more buy signals) will only come about as investors use their cash to buy stocks. When the Bullish %s turn down, especially from levels over 70%, supply (selling) is overcoming demand and often means a broad downside move is developing. Currently, an increasing number of Bullish % charts have given sells, including the S&P Mid-Cap Index and NYSE (below). While this doesn’t preclude tactical buying of specific securities (Gold? Oil?), overall we believe this is a market to be approached with caution.

We are positioned in a conservative way, and have been all year. Cracks are starting to appear in the rally that began last summer, and protecting the downside risk is a higher priority than aggressively seeking gains. The time to seek gains will eventually come, but for now it looks like the end of QE2, breadth breakdown, and unresolved Greek debt crisis may coalesce into a rough mix for the markets this summer.



The Bullish % charts help us to see what is actually happening in the market. While we can speculate about the end of QE2 all day long, the collective action of investors and their effect on price trends tells us how people are voting with their dollars, and hence what *action* they are taking regarding the future. By relying on these tools, rather than prediction, we hope to avoid the collective amnesia that is pervasive in the markets today.