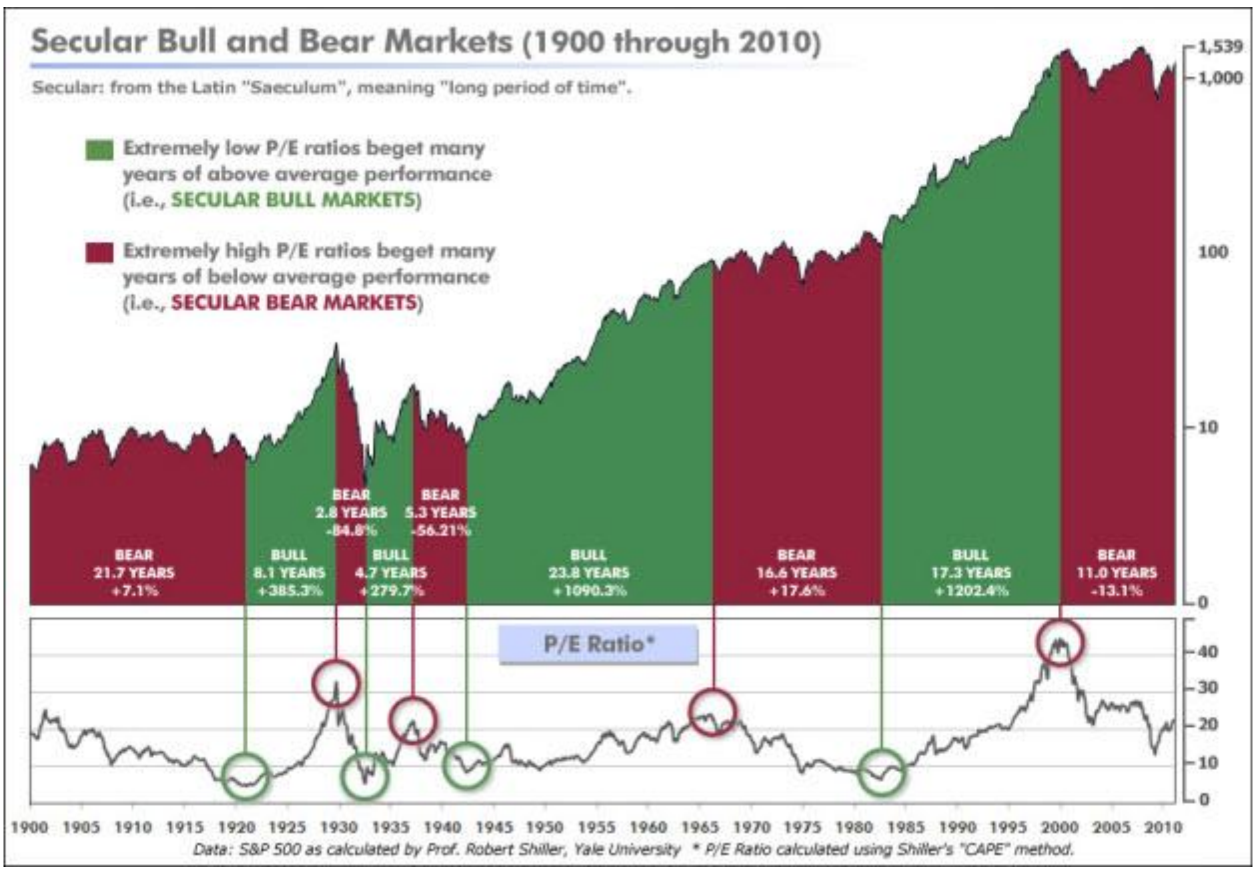
July 2011

Cross Currents

On March 24, 2000, the S&P 500 closed at 1,527 after rising with very few interruptions for an amazing 17 years. Investors believed in a new era of peace and prosperity and were willing to pay more for stocks than at any other time in the history of the U.S. stock market. Eleven years later, the S&P 500 sits at 1336 and is still down 13% in dollars and about 80% when priced in gold.

Long term cycles go from extreme euphoria (internet) to utter despair (price controls, riots over austerity in the US?). Although the S&P 500 was much cheaper in March of 2009 than in March of 2000, history suggests we have another 2-10 years to go before the next secular bull market arrives. There was a lot of despair in 2009, but nothing like the pessimism before the Battle of Midway in 1942 or the complete lack of interest in stocks in 1982.

Below is a chart that shows the secular (long term) bull and bear markets. Notice how long the red sections were and how little money was made in these sideways market. Below the stock market chart is the CAPE or cyclically adjusted price/earnings ratio for the S&P 500.



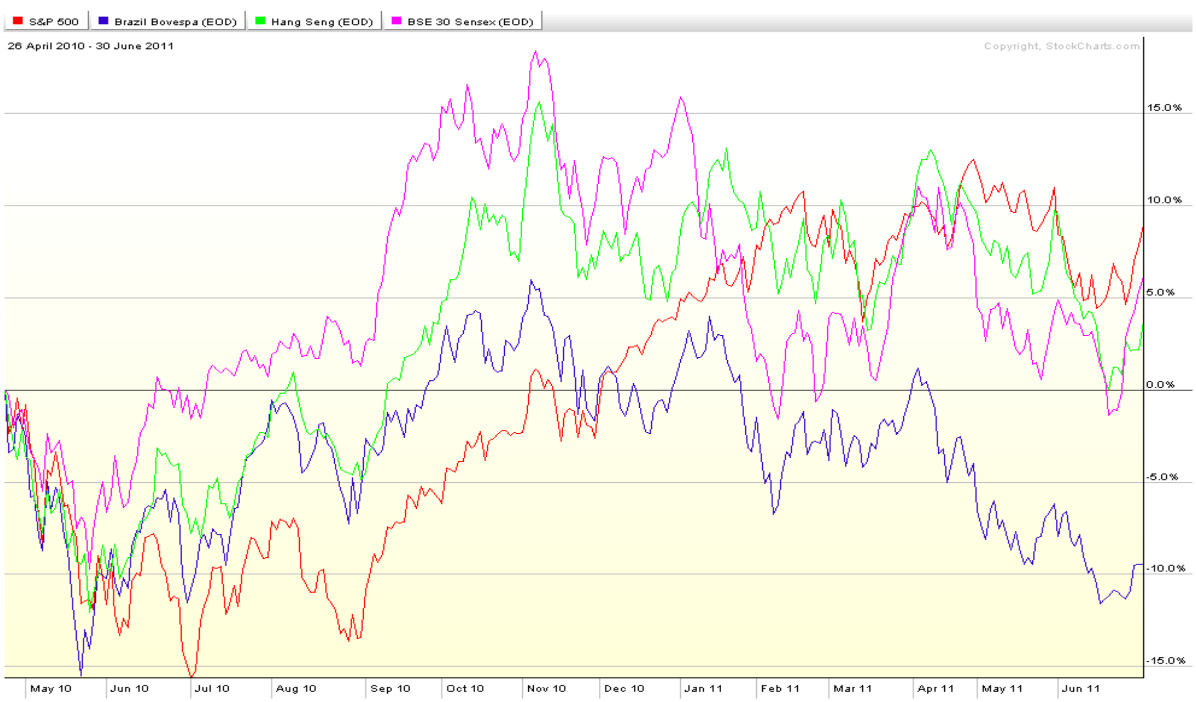
The CAPE was made famous by Yale professor, Robert Shiller, the co-inventor of the Case-Shiller housing index. When you hear someone say the P/E ratio of XYZ stock is 15, they are normally referring to the current share price divided by the trailing 12 months earnings. This calculation is very volatile and can register some very extreme readings at major turning points in the market.

The CAPE calculation smoothes out a company or market's earnings by using the ten year inflation adjusted average earnings instead of trailing 12 months earnings. The CAPE is currently registering 23 compared with a long term average of 17.5. Although 23 is a lot lower than the 46 print we got in 2000, the stock market is certainly not cheap today.

Since we are discussing p/e ratios; turn off the TV when you hear a commentator use forward p/e ratios. The forward p/e is the current price divided by the estimated 12 future months worth of earnings. The current forward p/e of the S&P 500 is 13 and many use this to make the case the stock market is cheap. Because Wall Street's earnings estimates are consistently wrong (especially at turns), the forward p/e ratio is only good for helping separate you from your wealth.

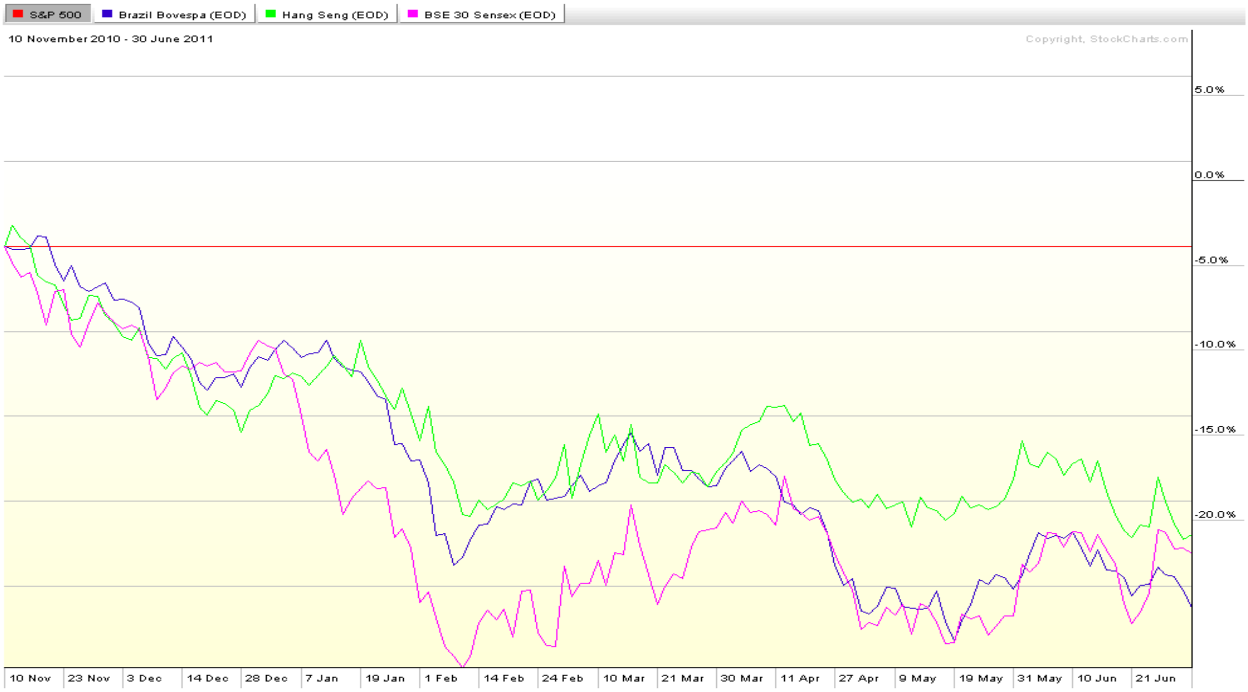
The main point that I am trying to make is that stocks are not cheap here and we are most likely still in a secular bear market. I doubt that we ever see the 666 low registered on the S&P 500 in March of 2009 again, but I think we have several more years of bouncing in a trading range before the next secular bull market takes off.

Not only have the last 11 years been difficult for investors; the last 14 months have been a volatile race to nowhere across several equity markets. Below is the S&P 500 (red), Brazil Bovespa (blue), HK Hang Seng (green), and the Bombay Sensitive Index (pink) since the April 26, 2010 high for the S&P 500.



Source: StockCharts.com

Despite the hype that all the growth in the world is coming from the emerging markets, their stock markets have been terrible places to invest for quite awhile. Clearly this has been a difficult time for investors. Below I have taken out the S&P 500 and rebased the chart to begin on November 10, 2010, the peak for many emerging market stock indexes.

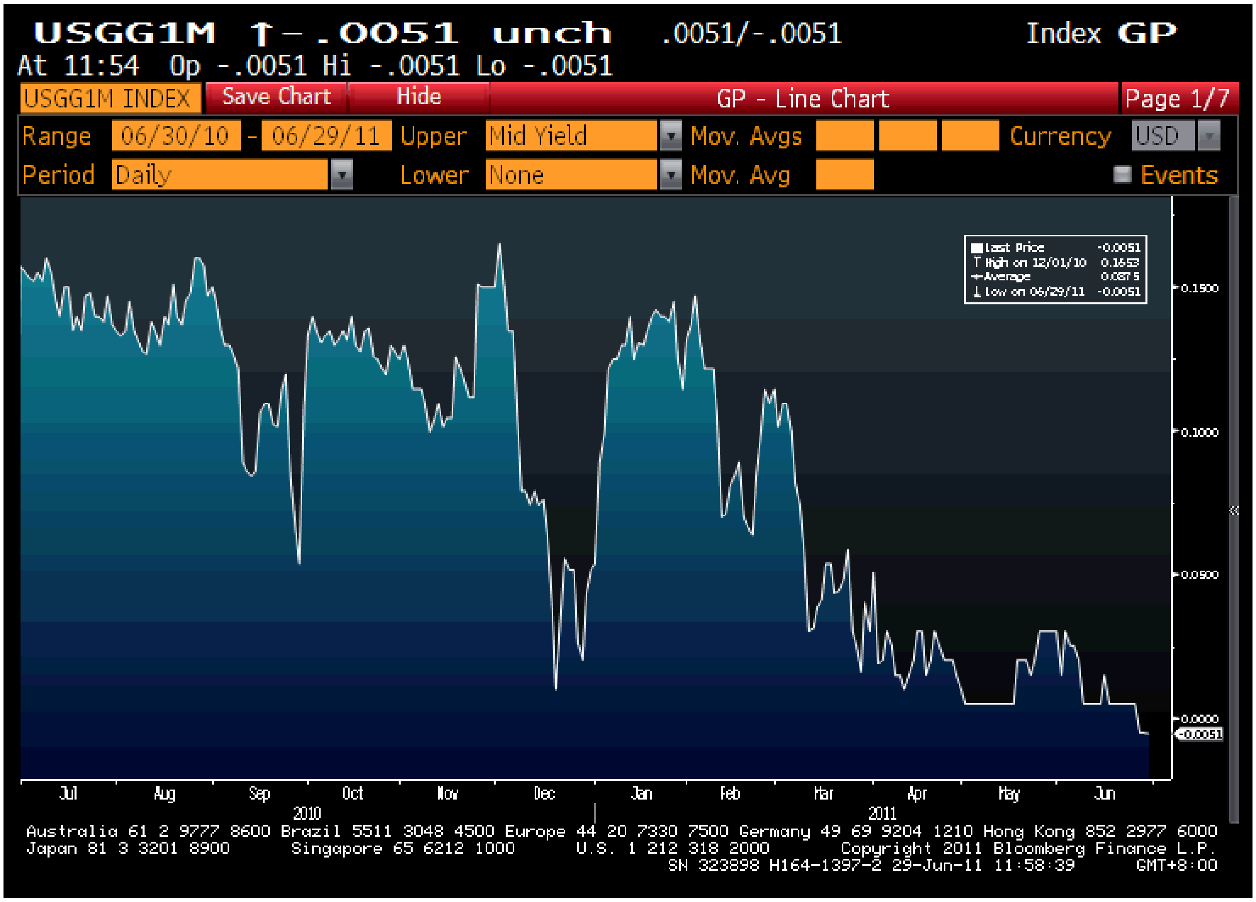


A Bear Market in EM, Source: StockCharts.com

A bear market is defined by a 20%+ correction from a peak and all three of the locomotives that are supposed to drive us to sustained global growth have entered a bear market. Someone once said that expansions don't die of natural causes, they are killed by central bankers. The Federal Funds rate is currently zero. This has caused an enormous amount of speculation and inflation; especially in emerging markets. While our central bank fights to try to keep home prices from dropping another 20%, the emerging market central banks have been raising interest rates in order to fight the same food inflation that has toppled governments in the MENA area.

India's central bank recently hiked its interest rate to 7.5%, Brazil's rate is 12.25%, and China's one year lending rate is 6.31%. While other countries try to fight inflation, Ben Bernanke seems content to leave the US with a zero percent interest rate policy forever. After all, in his mind the massive rise in commodities since quantitative easing two was announced is only "transitory."

While the U.S. stock market has been soaring, there is a very interesting development going on in the short term treasury market. The chart below shows that the interest rate on one month Treasury notes recently went **negative!** This means that investors are so terrified of getting their money back, that they will pay the U.S. government to borrow money. Unbelievable!



The 1 month goes negative. Source: www.acting-man.com, Bloomberg

I am not sure if condition is being caused by Europeans fleeing their banking system, U.S. money market investors concerned about how much of their money market investments are being lent to European banks, or concern that global stock markets have peaked for the year and still have some correcting to do.

Clearly the market is discounting more losses at the banks. Below is a chart showing some of the prominent financial companies this year. Investors are fleeing these companies in droves.

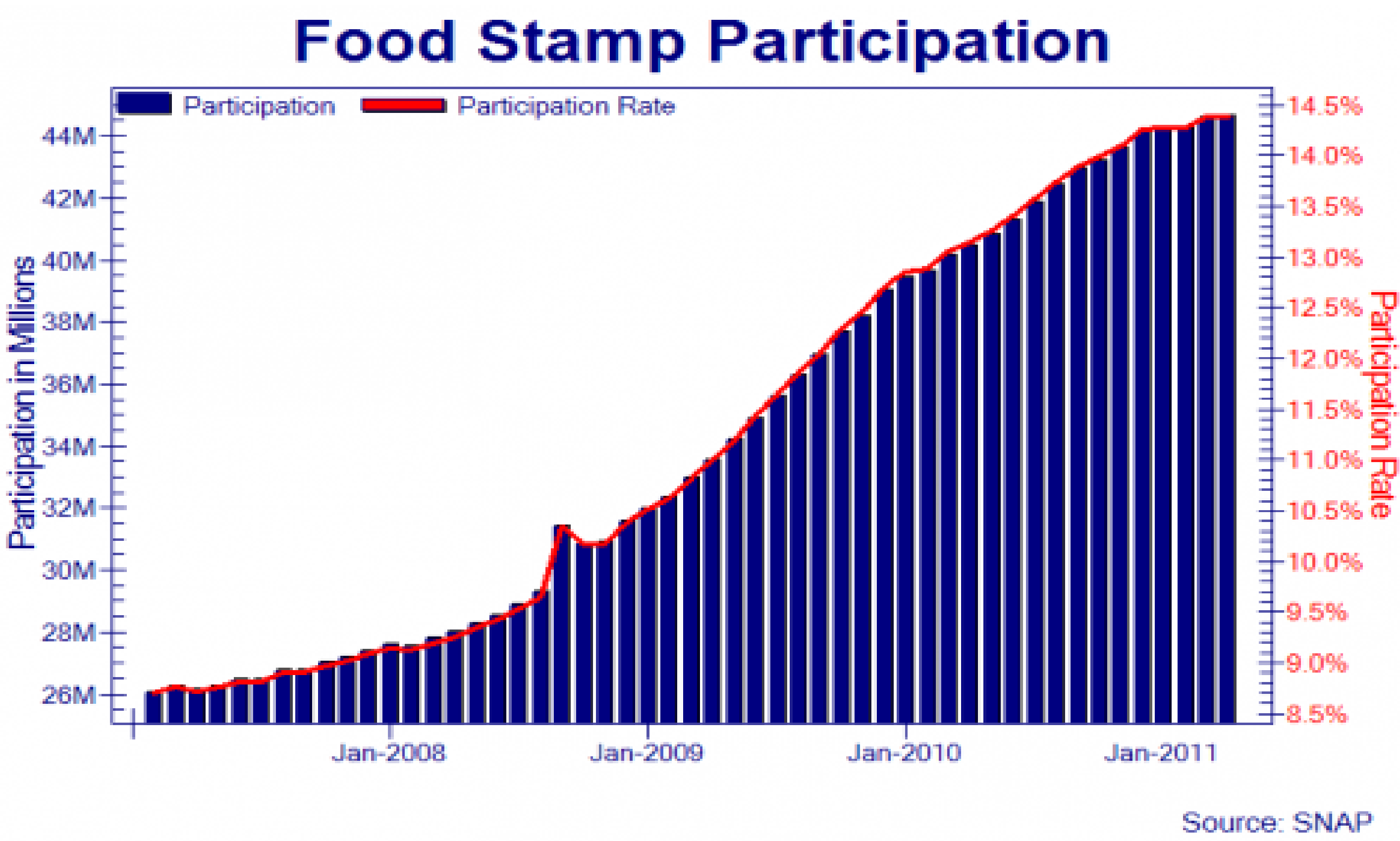
Run don't walk! Source: Yahoo!Finance

One of the only values I see seems to be the gold miners. Below is a chart of gold divided by the GDX Gold Miners ETF. Many miners are trading at the same price they were when gold was only $1000 per ounce in 2008. The miners have not been this cheap relative to the price of gold since 2008. Dr. John Hussman sees value in the shares and has been buying them recently. On June 13, he wrote, "Notably, and in contrast to the broad stock and bond markets, our measures of prospective return/risk in gold shares has surged, with falling long-term yields, negative real interest rates, weakening economic statistics and a very high gold/XAU ratio all provoking a distinct jump in our expected return/risk measures for gold stocks."[1]

Bullion has outperformed the shares in 2011. Source: StockCharts.com

The only thing soaring more than the U.S. stock Tiffany's stock (TIF) is the number of participants in the USDA's Supplemental Nutritional Assistance Program (SNAP). There is now a record 44.647 million Americans receiving approximately $282.38 per month in household food stamps![2] With a population of 310 million, that is one in seven Americans on food stamps.

[1] http://www.hussmanfunds.com/wmc/wmc110613.htm
[2] http://www.zerohedge.com/article/record-447-million-people-celebrate-geithners-departure-and-end-qe2-through-foodstamps



One is seven ask, "What recovery." Source: Zerohedge.com, SNAP

The future is never certain, but now seems to be a time that is particularly unclear. The European banksters were bailed out a little over a year ago via Greece's first bailout. A rally has ensued from the bailout and better than expected economic data from the United States. The problems in Europe are still there and it is impossible to "save" a country that has too much debt by issuing them more debt that they will never be able to pay off.

In addition to the stresses in Europe, the last day of QE 2.0 (money printing) ended on June 30th. The stock market began a significant correction after the end of QE 1. This time, the stock market started correcting *before* the end of QE 2. July often sees a mid-summer bounce in the stock market and August and September are some of the worst months of the year for stocks. It is hard to say if we will follow the typical game plan for the stock market this year. Some of the biggest questions that remain unanswered are: will congress begin to cut the budget this year, when will a European Government finally default, and when will Bernanke announce the next round of money printing?

With so many cross currents here, I think this is not the time to be brave. Every time I play poker, I always remember that the best poker players only play one to two hands per hour. They wait for the hand where the odds are in their favor and they make big bets when the risk/return makes sense.

The S&P 500 is up exactly 100% in the last 2 years and four months. If we are still within a secular bear market, there is probably not a lot of upside to be had. I continue to favor the U.S. stock market over international stock markets and I am starting to see more and more investors shifting from the riskier sectors into health care, consumer staples, and utilities.

There is a good chance that many of the world's stock markets have seen their highs for the year. How long the U.S. economy continues to grow without much help from emerging markets remains a big question mark for me. My best advice is to be patient in these frustrating markets and don't take unnecessary risks. There will be another great buying opportunity to make lots of money again. Until it shows its self, the name of the game is to preserve your capital so that you can buy 'em when everyone else is selling.

DOMESTIQUE
Capital

Domestique Capital LLC
4601 Old Shepard Place
Ste. 117
Plano, TX 75093
214.556.8904 phone
www.domestiquecap.com