

This is an original article written by Philip Loh; the edited version appeared in the Business Times 19th July 2006.

Dangers lurk in the dark waters

The global stock markets are now in their early stages of a cyclical bear market and the greatest danger facing investors is entering the market too early. Like all bear markets, this one may take its time bottoming out. Furthermore, investors' sentiment has not reached the extreme negative that signifies a bear market bottom. So, resist the temptation to bargain hunt and stay on the sidelines for protection as the bear market patterns establish itself. As the sage advice goes, "When it is the time to buy, you won't want to."

The current decline is especially dangerous because many investors appear unfazed by the bearish signals and expect a summer rally as we march into the 2nd quarter of the earnings-reporting season. This is a classic contrarian signal because the downturn could be deeper and more prolonged than it seems. Yet, most still think that the recent market turmoil is no more than a passing storm.

Markets have until recently been totally ignoring the growing number of negative signs. Even with the recent market corrections, the bulls or 'Extrapolators' are claiming that this is a healthy correction and investors should make use of the opportunity, like they did last May and October, to snip up stocks at bargain prices.

Let's examine the negatives signs:

- 1) One of the greatest risks is that investors have failed to discount for the historical high profit margins in their calculation of the PER (Price to earning ratio), the main valuation yardstick for stock. The bulls claimed that the PERs for the global markets are near their historical averages, and have become more attractive with the recent corrections. At 8.5%, gross profit margin is at its highest in 50 years. A reversion to mean gross margin of about 6% could easily wipe 20% off current valuations. Paying for average PERs on peak earnings and record margins late in an economic expansion cycle is certainly not the best way to get rich.
- 2) The US yield curve, a strong leading signal of a recession, has become inverted again. Because the stock market is a leading economic indicator, if the US economy is going to have a recession, the stock market is going to perform badly in advance. Many investors are predicting that "this time is different" and would be the same as 1998 when a yield curve inversion did not lead to a recession. Others believe that even if US does go into a recession, possibly from a slump in consumer spending, European and Japanese consumers would be able to pick up the slack. And with emerging spending powers like Asia and China, a global recession could be averted. This is perhaps the same confidence that pervaded in Asia during 1996-97 before the Asian currency crisis struck. Note that the China and Asian economies constitutes no more than 10% of the global economy. The economic recovery in Europe and Japan may be too weak to withstand a sharp drop in export demand resulting from a US recession.

- 3) The US housing ATM is shutting down. The US housing bubble had run for the past 23 years from 1982 to 2005. Housing costs is over six times of family income, while the long-term average is actually below four. Young Americans simply cannot afford houses at this level. US consumers have capitalised on soaring house prices to extract equity from their homes through re-mortgaging. Together with expanding credit card debts, they are spending more than they earn. As the US housing bubble deflates, consumer spending, which make up 70% of the US economy, is expected to remain soft for quite a while.
- 4) Mutual fund cash positions have declined to a record low and such low readings have in the past preceded major market corrections. The rationale is that mutual funds are long-term investors and a high cash position would allow them to buy on market dips, hence providing some baseline support for the market. Moreover, if there is significant fund redemption, the cash position can be utilised without liquidating the fund's stock holding. Fosback, a famous editor of various stock market newsletters, developed a market-timing model that is based on the amount of mutual funds cash holding. He considers it bullish if fund managers hold lots of cash, and bearish if managers hold very little cash, like now. Fosback's model is currently projecting that the S&P 500 index will produce only a 2% annualised return over the next five years. For mutual fund investors in Singapore, it means that the net return could be close to zero after netting off the relatively high fund expenses.
- 5) Interest rates in Europe and Japan are expected to rise from their historical lows, providing additional head wind to equities. Inflationary pressures are on the rise in both Japan and Europe, forcing the EU and the Japanese government to raise interest rate probably faster than they would normally. Inflationary pressure is highly unlikely to abate in the near term with high oil and commodity prices. More importantly, significant wage inflation in China and India is pushing up import prices in the developed countries. The secondary effect of all these inflationary factors may give the Federal Reserve no leeway to pause even after 17 consecutive rate increases.

Many prominent Wall Street experts have raised the red flag. These include people from the technical side like Michael Kahn and John Murphy, fundamentalists like Jeremy Grantham and Knott Capital and research people like Ned Davis Research, Hirsch and Lowry's Organization. It does seem that there is a record number bears stretching their paws, waiting for the right conditions to set them into demolition mode. The nail to the coffin of this aging bull market may well be some nasty earnings disappointment.

Then again, I could be wrong, and the bulls may well have their way again this summer as earnings numbers, a lagging indicator, prove resilient. Quoting the late renowned analyst Lucien Hooper, "the stock market will do whatever is necessary to frustrate the majority of participants." With the many hidden dangers lurking on the horizon for the stock investors, patience is the key that may translate to gold in a matter of time.