

Perception & Reality in Sync Again

May 22, 2006

We have communicated to our clients and Web Buzz friends over the last 30 days the possibility that another 1987 may be at hand. From what we have seen over the last week, it looks as if it might well have started. Obviously, one never knows until hindsight becomes your friend. Of course by then (after the stock market crash) it is too late, the damage will already be done if one is heavily invested in common stocks. Along with an expected decline in stocks, we expect a snapback in high quality bond values, which have trended downward since the first of the year.

All of the above is based upon our fundamental outlook for the US economy. As stated many times before, we are dumb founded as to how the financial community came to the conclusion the end of 2005, that the economy and inflation were headed for the moon. We have had to date, the weakest economic recovery and expansion post WWII. Income and employment growth has been less than stellar and only government deficits and heavy borrowing on the part of consumers have kept the economy going. We anxiously await the new debt numbers for the first quarter, which will be available around the 9th or 10th of June. Our best guess is that the first quarter, on an annualized basis, will again be strong, but may well be the last, since the housing industry is in the tank. Most bank prime rates are 8%, and at 8% most deals will not work. The Fed has overdone on the upside taking the Federal Funds rate to 5%, just as they did on the downside at 1%. That is the bad news, and the worse news is they may not be done. They continue to pay more attention to coinciding and lagging indicators as opposed to the leading indicators.

Jeff Pieters has called our attention to some interesting work done by John P Hussman PHD, concerning S&P 500 peak earnings and P/E ratios at that level. If one assumes we are at the crest in earnings, coupled with a P/E ratio between 17 and 18, the stock market is overpriced. Not as overpriced as 2000's 28 times, but nowhere close to a multiple of 10 to 12, which is "normal." The chart below shows the earnings are cyclical as compared to a 6% straight-line growth depicted by the upward sloping straight line. Six percent has been the long-term growth rate since 1950. If history is any guide, we should expect approximately 5 years of sub-normal earnings, which should prove to be a tough hill for stocks to climb.

All of this points toward a recession and the eventually lowering of short-term interest rates by the Fed and long-term interest rates by market participants. Nothing of course goes in a straight line, but economies and market psychology seem to finally be back in sync again.

