

Strategy Research

Global Strategy Weekly

Market sentiment ripe for its anaesthetic-free vasectomy. And trust me, it hurts!

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After missing the sharpest five week rise in US equities since the 1930's I feel bad. I have even started having disturbing dreams that the global economy is about to boom and I am still heavily underweight equities. There is much hope out there that the current moderation of recessionary forces is a prelude to recovery. I believe that the current market situation is like late 2001/early 2002. Any relapse in activity will cause a catastrophic loss of confidence.

■ The equity bulls have gained the upper hand. The market isn't so much climbing a wall of worry as leaping over it. To be fair there have been some unambiguous signs that things are getting worse at a less rapid pace (is that the same as things are getting better?). For example, many cite collapsing global production as having now eliminated excess inventories. But take a look at the chart below and think again! (more on this later).

■ You might think that the deepest downturn since the Great Depression might mean that the beleaguered consumer would be too depressed to engage in sexual activity. Indeed a story I saw on Reuters showed that nearly half of British men surveyed would give up sex for six months in return for a 50-inch plasma TV – [link](#). Not a bit of it. Reading my latest edition of *Plastics and Rubber Weekly*, I see that SSL, the UK group that makes Durex condoms, reported ballooning profits on the principle 'we can't afford to go out, so we better stay at home and amuse ourselves' – [link](#). Going even further, my former colleague, Ian Harwood, pointed out a New York Times report of a sharp rise in US vasectomies as people lose their jobs – [link](#). This reminds me of my own visit to one of leading chain of clinics in central London a few years back. I suppose I should have been a bit more vocal when I was asked if a trainee doctor could perform the procedure - albeit supervised by the head of the clinic. But I felt in safe hands and nodded. What could go wrong? Well, about two minutes into the procedure I realised maybe quite a bit. I can still hear the words of clinic boss to the trainee - "oh dear, I wouldn't have made that cut there, if I was you"!

Global asset allocation

%	Index	Index neutral	SG Weight
Equities	30-80	60	35
Bonds	20-50	35	50
Cash	0-30	5	15

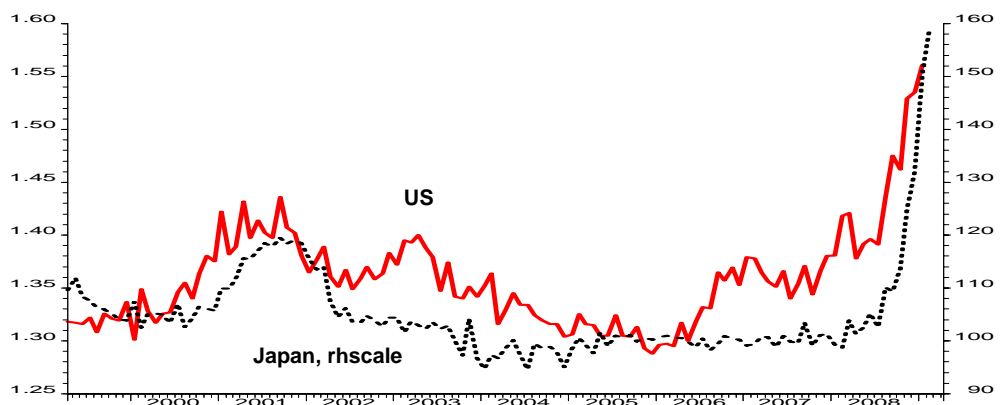
Source: SG Equity Research

Equity allocation

Very Overweight	
Overweight	US UK
Neutral	Cont Europe
Underweight	Japan Emerging mkts
Very Underweight	

Source: SG Equity Research

US and Japanese manufacturing inventory/sales ratios (real). Apparently production cuts have cleared the inventory backlog!!!!



**IMPORTANT: PLEASE READ
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Lying horizontal, under local anesthetic, my mind ran riot as to what had happened. I decided to try and look on the bright side. I dimly recalled my tour around the Topkapi Palace in Istanbul some 20 years earlier. Hadn't the Chief Eunuch been one of the most powerful and revered members of the Turkish Sultan's court? Why I didn't call it quits at that point and hobble out of the room I shall never know. Maybe I thought that things couldn't get any worse. Unfortunately that proved to be yet **another** bad call from Edwards!

Half way through the procedure, 'things' seemed to be getting a little frantic. My voice shaking with trepidation, I asked if there was a problem (another!), only to be told that "*we've lost something, but don't worry, we know it was here at the start because we checked*". After what seemed an age the second part of the procedure was completed. It must have been an age, because unfortunately the anesthetic had worn off by the time they got around to lasering through my tender bits. It was some considerable time later that Dr Snip and his trusty assistant, Slasher, scraped me off the ceiling weeping with pain.

Human nature being what it is, the more the equity market rallies, the more confidence grows that we are past the worst. There is a lot of hope out there. Therein lies the problem. I was reminding myself of the words of the sage author of the *Dow Theory Letters*, Richard Russell. He believes that "hope" is a major impediment to investing. He believes that although it's human nature to be optimistic and it is a healthy state of mind, ironically it doesn't work in the stockmarket where it is a hindrance rather than a help – [link](#).

Investors simply did not give up hope when the S&P visited 666 last month. Where was the universal excess bearishness that typically marks the end of major bear markets? I sense there is a lot of hope out there that this is the real thing. But before I can go overweight equities, I need not just cheap valuations, I need to see despair and revulsion.

That despair might not be so far off though. **If, as I expect, investors decide that the green shoots they are seeing are just weeds, the resultant loss of confidence in an economic recovery will undoubtedly see the equity markets make substantial new lows.**

I suppose I see the current situation as a bit like the market rally towards the end of 2001. At that time, the market's 25% rally was reasonably firmly underpinned by green shoots and hope. When that vanished in mid-March 2002 frost, the equity market quickly plunged a further 34%. That final lurch down did indeed feel like a vasectomy without anesthetic. Ouch!

One area where there is clearly a lot of hope at present is that the recent production cutbacks have been so deep that they have run off unwanted inventory. Many commentators believe that the process has been completed and they therefore expect GDP to bounce back in the second half of this year as production schedules are adjusted back upwards.

To be sure, in the US inventories have declined sharply over the past year in each and every quarterly GDP press release. That has given many in the market the mistaken impression that inventories are lean – they are not.

The two charts below show total US business inventories relative to sales in different ways. US inventories have indeed declined a sharp 3.5% yoy, but nominal sales growth has collapsed 13% (see right hand chart). Inventories need to be cut much, much further – not just in the US, but also as we saw from the chart on the front cover, in Japan.

US business inventory/sales (manu, wholesale & retail)



Annual yoy growth of US business inventories and sales



Source: Datastream

Yet looking back, production cutbacks have tended to continue in response to excess inventory *until* demand begins to bottom out. We do not want to be misleading. A fall in the I/S ratio back to low levels is *not* historically a precursor to economic recovery. It is a lagging indicator. If retail demand picks up on a sustained basis, it will ultimately ripple its way through the production chain. Indeed looking into the sector composition of US business inventories, the retail sector has managed to get its excess inventory problem under control far quicker than either wholesalers or manufacturers (see chart below).

Breaking excess US inventories/sales ratios into their components (nominal)

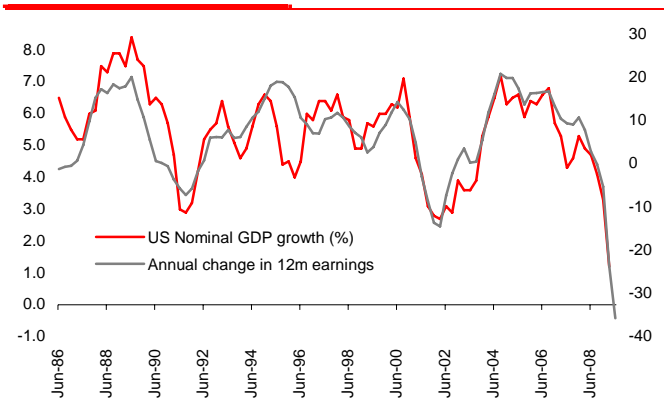


Source: Datastream

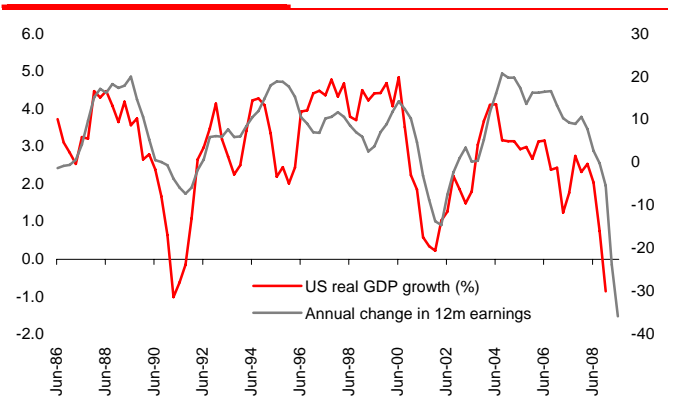
The *good* news is that as retail sales recovered in January and February, this enabled retailers to get some sort of grip on things. Retail inventories have declined some 7% yoy compared to only around 2% for wholesalers and manufacturers. But if as the March retail sales data now suggests the recent buoyancy in consumer demand is an aberration, then there remains a big, big problem of excess inventory backed up in the production process (incidentally US manufacturers carry more inventory than either retailers or wholesalers).

One other area where the market seems excessively complacent is revenue growth. Despite the unusual depth of the current recession, companies and their analyst mouthpieces are still being caught out on the downside with regard to profit growth. Why? The answer is in the 13% nominal collapse in business sales we showed above. *Nominal* profits growth overlays *nominal* revenue and *nominal* GDP growth, NOT real GDP growth (see charts below borrowed from my Quant colleague Andrew Laphorne).

US nominal profits growth overlays nominal.....



.....not real GDP growth

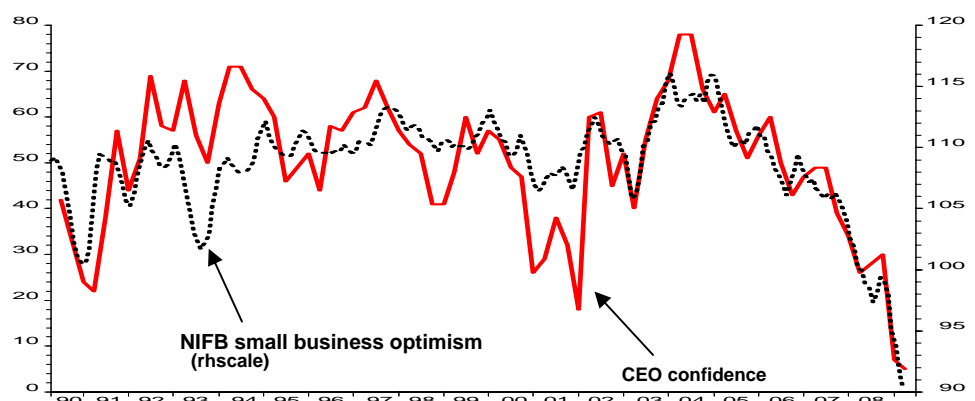


Source: SG Equity Research

It is the declines in *nominal* GDP that are so shocking and that investors should be focusing on, not just the slump in real activity. Despite the massive monetary stimulus that is passing through the system, deepening deflation is continuing to catch out both investors and companies. And with capacity utilization at unprecedented lows and output gaps so large, it is wholly unsurprising that nominal quantities are contracting so rapidly.

That was a feature of Japan during in the 1990s. Companies didn't have a clue what was happening to them as *nominal* GDP collapsed. It was new. No wonder those at the pit face such as US small businesses are still so bearish. Hell, the news has even filtered its way back to the company CEOs (see chart below)! On this measure things are far worse than they were in early 2002 with no rebound in optimism yet evident. That is why jobs and investment continue to be slashed. Companies are fighting hard to restore nominal profitability.

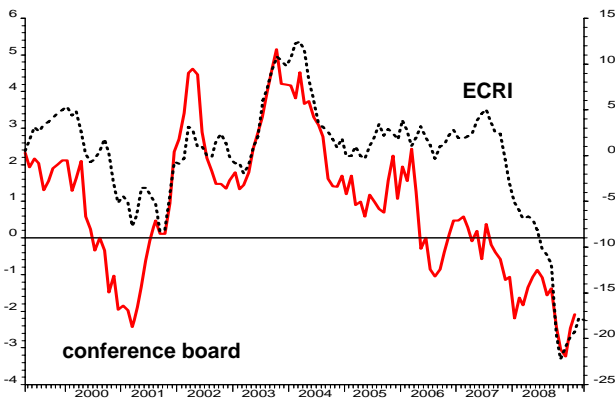
US NIFB small business and CEO optimism



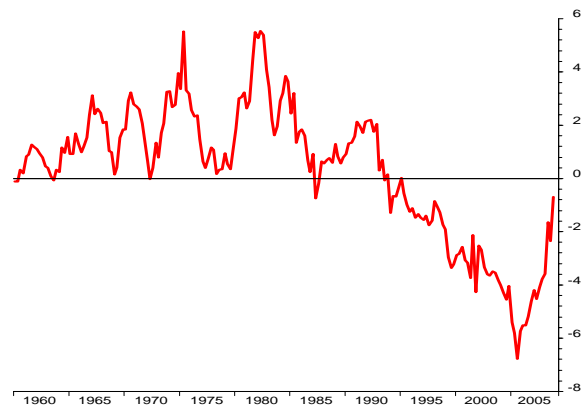
Source: Datastream

Let me be candid. Regular readers will know I put my hands up and nominate myself for *Arse of the Year* award when I get things wrong. Despite being willing to shift the equity weighting around I have totally missed the strongest five week rally in US equities since the Great Depression. I also have to hold my hands up and admit that some of the key leading indicators I monitor have begun to turn upwards (see left hand chart below). Lakshman Achuthan, MD at the ECRI said Friday "With the upturn in Weekly Leading Index growth continuing for over five months now, growth in U.S. economic activity will begin to improve in short order" – [link](#). Yet compared to the late 2001 upturn, the uptick in lead indicators remains just that for the present – an *uptick*. And regarding the fundamentals, it is worth pointing out two things. First, the household sector borrowing requirement, although massively lower than the grotesque excesses of a few years back, still remains in slight deficit (defined as income minus consumption and investment). That means the **de-leveraging – the paying down of excess borrowing of the last decade – has not even begun** (see right hand chart below).

US conference board and ECRI lead indicators



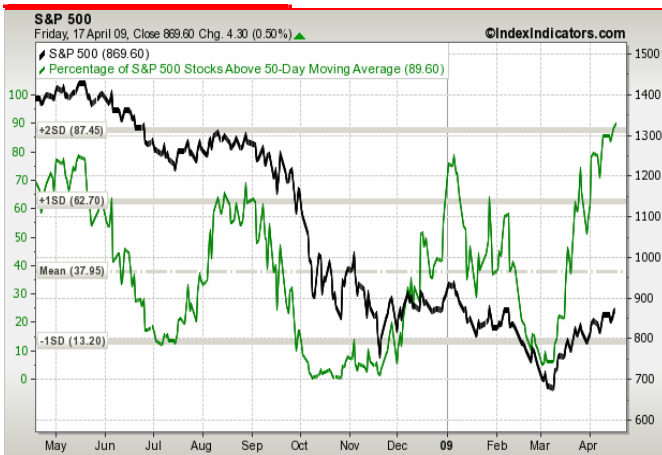
US household sector savings/borrowing balance (% GDP)



Source: Datastream

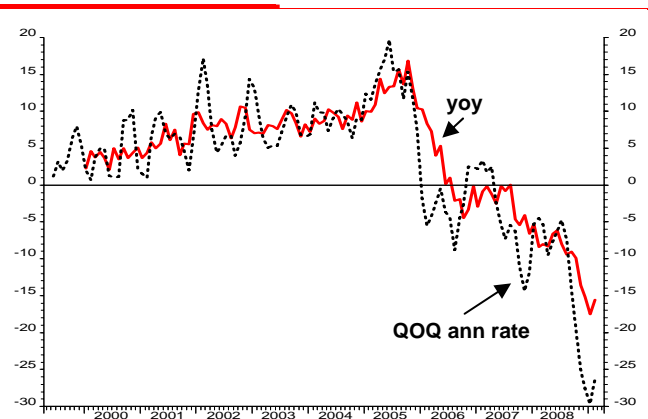
Second US house price deflation is *accelerating*, not as some people suggest, bottoming out (see right hand chart below). In my view it is still too early to go bullish. But for those readers who disagree, I would certainly caution piling in with technical indicators so very overbought (see left hand chart below). But I still believe that the worst of the bear market still lies ahead.

S&P and % of stocks above 50 day mav



Source: indexindicators.com

US House Price Inflation: Existing Homes



Source: Datastream

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