Foggy Bottom?

Foggy Bottom is an old neighbourhood in Washington, D.C., so named because of the vapours rising from the swamp. We are hopeful that it is also an apt name for the current market environment, which has numerous characteristics associated with stock market bottoms. That said, the outlook is clouded by noxious vapours rising from the financial swamps.

Some characteristics of market bottoms that seem present are extremely negative sentiment, low price-to-earnings ratios, and proactive central banks. But the vapours that are obscuring the outlook include the ongoing slump in U.S. real estate and legitimate fears of a vicious circle that could overwhelm well-intentioned central bankers. Specifically, the fear is that economic recession will trigger sharply rising unemployment, leading to a deeper real estate slump, which will lead to further credit market distress, which will deepen the recession, and so on.

To prevent such a vicious circle, the Federal Reserve has been hyperactive and cut interest rates by three percentage points from last September to March 18. However, some prominent economists are already fretting that the Fed could be "pushing on a string" and has little ability to arrest the downturn. We doubt that is the case, and would refer interested readers to various speeches and interviews with Fed Chairman Ben Bernanke, who has outlined all of the various tools at the Fed's disposal to prevent worst-case scenarios. We believe the Fed's efforts will eventually succeed, which is why we are not in the Armageddon camp of investment managers.

The World After Bear Stearns

The demise of Bear Stearns as an independent entity was a momentous event for global financial markets and has ushered in a new dogma: The largest broker-dealers are now deemed too big to fail. They are now recognized as being just as crucial to the health of the global financial system as big banks have been. To prevent cascading failures in the global financial system, they will now be backstopped by the full faith and credit of the government. However, the price is likely to be a far more comprehensive regulatory environment.

The Fed's decision recognizes that in the brave new world of complex swaps, credit derivatives, securitized lending, and structured products, a run on key non-bank institutions could be just as devastating to financial stability as Depression-style runs on large commercial banks. That risk has now been appropriately addressed. In March, equity markets started to recover, with major indexes having bottomed just short of reaching the conventional definition of a "bear market" decline of 20% (in U.S. dollar terms).

If massive monetary and fiscal stimulus is able to limit the U.S. recession to a short and shallow one, then we believe there is a good chance that global financial markets have bottomed and are capable of rising to new highs over the next year or so. As we show in Table 1, equity market valuations look quite attractive relative to bond yields, with the global market trading at about 12 times estimated earnings over the next 12 months. That means, based on a simple "Fed model" type of comparison, equities are nearly 50% undervalued relative to government bonds.

Alternatively, it means that government bonds are now notably overvalued relative to equities. It also suggests that equity markets have largely priced in the potential for

Valuation Comparison: International Stocks vs. Bonds

Data as of March 13, 2008

	12-Month Forward P/E Ratio	Earning Yield	10-Month Nominal Bond Yeld*	Relative Valuation Stocks vs. Bonds
U.S.	13.3	7.5%	3.9%	-48%
Europe ex. U.K.	10.5	9.5%	3.8%	-60%
U.K.	10.9	9.2%	4.9%	-47%
Japan	12.9	7.8%	1.3%	-83%
World	12.1	8.3%	3.9%	-53%

*Weighted average for World and Pacific ex. Japan using MSCI World Index weights.

Source: Lehman Brothers, Bloomberg, Trilogy Advisors

Table 1: Most international stock markets currently trade at low price-earnings ratios and are attractively valued relative to government bonds.

corporate earnings to fall by 20% to 30% in a recession. With Fed officials likely to continue easing until they are sure they will deliver an economic recovery, we have entered a "cash is trash" type of environment. Short-term U.S. interest rates are significantly lower than the inflation rate, which has created strong incentives for investors to step out on the risk curve in terms of exposure to both credit and equity risk. If the desired response is not forthcoming, the Fed will ease further.

In addition to the favourable valuation argument for equities, we would point to the extremely negative sentiment. One may pick from a variety of measures of capitulation, including massive outflows from U.S. equity mutual funds, but we will focus on one measure of particular interest – the U.S. consumer confidence indicator tallied by the Conference Board. As shown in Chart 1, that indicator reached 64 in February, a level that is typical of recessions and akin to readings seen during the Watergate fiasco. Contrarians take note: Since 1968, readings of 65 or below on that indicator have been followed by returns on the S&P 500 averaging nearly 19% over the next 12 months, compared to returns during other periods averaging only 10%.

Risks: Financial Shocks and Inflation Fears

Obviously, there are risks that the recession will be long and deep and that the Fed's countermeasures will fail. Here is one reason to be optimistic that a long and deep recession can be avoided. Even though sentiment surveys have generally been awful, various measures of actual economic activity have been holding up reasonably well, particularly when compared to past recession periods. For example, the rate of increase in initial jobless claims has been very modest so far compared to past recessions, as has been the trend in the unemployment rate. While 70% of economists have shifted to forecasting recession, the 30% who have not are drawing attention to such data as indications that the jury is still out.

At this point it may be quibbling to debate whether the economy is in recession or not, since it is clearly in a severe slowdown. The key issue for markets now is whether the slowdown will be short and shallow or severe and prolonged. So far, at least, the data remain supportive of the short and shallow outlook. So too is any reasonable interpretation of the Fed's aggressive policy stance. Another widely noted positive is that the world economy is well positioned to absorb the shock of the U.S. slowdown and could benefit from a corresponding reduction in inflation pressures (more on that in a moment).

The biggest risk factor is whether there will be more spectacular failures of hedge funds or financial institutions that lead to the vicious circle problems mentioned above. A key reason for cautious optimism is that the acute risk of a

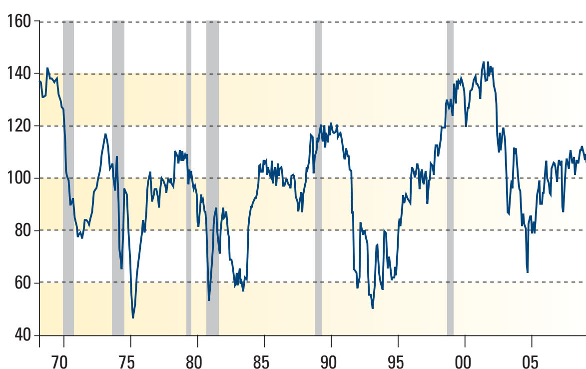


Chart 1: Consumer confidence in the U.S. fell sharply in the first quarter to levels typically associated with economic recessions in the past.

cascading sequence of bank and/or broker failures has now been addressed forcefully. That said, it would not be surprising if the real estate slump were to claim more victims among hedge funds or financial institutions. Naturally, financial analysts will have their hands full trying to gauge the impact of the emerging regulatory environment on the profitability of many financial institutions, which likely will have to live with less leverage.

Extraordinarily low yields on government bonds, with maturities ranging from two to five years, imply that most market participants now expect interest rates to remain low for an extended period of time. That was the case following the savings and loan crisis of the early 1990s, when an extended period of low interest rates was needed to offset the impact of more cautious business practices among financial institutions.

The other risk investors have focused on recently is that of rising global inflation, perhaps resulting as an unintended consequence of the Fed's efforts to prevent a deflationary credit meltdown. To a large extent, concerns have been triggered by surging commodity prices, with the Commodity Research Bureau Spot Index having risen at a 30% pace in the first two months of the year. Additionally, a broad-based acceleration of inflation in emerging market nations has been evident. Most notably, China has seen inflation accelerate to a year-on-year pace of nearly 9% in February, compared with less than 3% a year earlier.

The extraordinary pace of commodity price gains in recent months seems odd against a backdrop of recessionary conditions in the U.S. and sluggish growth in Japan and much of Europe. Although dollar weakness can explain some of this, commodity price increases recently have been notable even in euro and yen terms. We think that continued strength in major emerging market economies like Brazil, Russia, and China explains part of the puzzle. Leading indicators for those countries, which are available from the OECD through December 2007, were pointing toward very strong growth in the first half of 2008. In addition, the Fed's aggressive rate cuts have undoubtedly fuelled speculative demand for commodities, with strongly negative real interest rates supporting asset allocation shifts toward hard assets.

The dilemma for the Fed is this: If commodity prices continue to rise at recent rates or even accelerate, the Fed could find its hands tied and be unable to respond further to the gathering forces of economic recession.

We think the Fed is likely to catch a break for two reasons. First, commodity prices have historically tended to fall within six months of a decline in global economic leading indicators. Since last November, the OECD's main leading indicator has been contracting on a year-on-year basis, so it would not be surprising to see a chill on commodity prices over the next few months. Second, with China having now become the major swing factor in demand for many commodity markets, it has not escaped our notice that China's A Share market has seen a decline in price of more than 40% since last October. If China's stock market has any value as a leading indicator, it is pointing to slower growth ahead. The more fundamental factor suggesting a slowdown in China is the sharp rise in required reserves depicted in Chart 2. That has reportedly made bank credit so hard to obtain that interest rates on the underground lending market have risen to 15% per month.

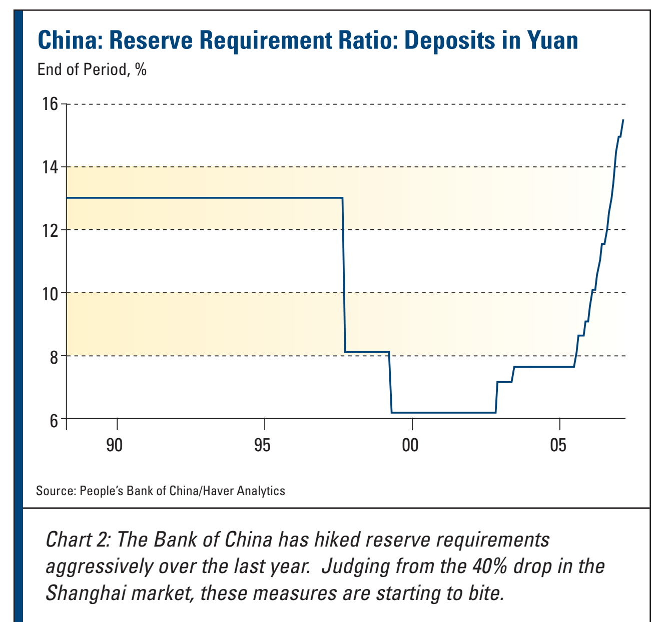
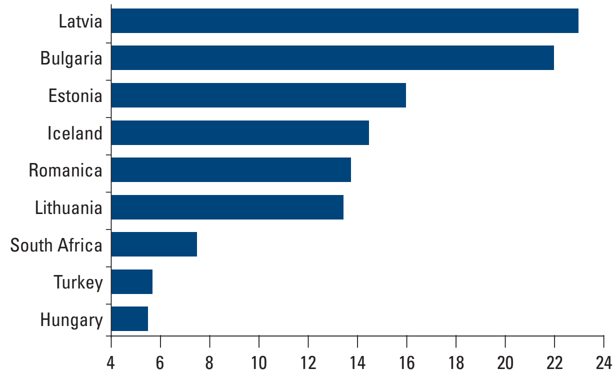


Chart 2: The Bank of China has hiked reserve requirements aggressively over the last year. Judging from the 40% drop in the Shanghai market, these measures are starting to bite.

Vulnerable?

2007 Current Account Deficits a Percent of GDP



Source: UBS, Wall Street Journal

Chart 3: Countries that have relied heavily on foreign investors to sustain debt-fuelled growth are under pressure to raise rates to prop up their currencies.

Developments on the periphery of Europe also point to a potential diminution of inflation concerns, with interest rates rising sharply in nations like Iceland, Hungary, Romania, Turkey and the Baltic Republics, to name a few. One characteristic these nations share, as shown in Chart 3, is a strong dependence on large inflows of foreign capital to finance their growth. With major financial institutions reducing leverage, fund flows to these countries appear to be under pressure. That requires them to raise interest rates to support their currencies and attract foreign capital. But the price is likely to be much slower growth and painful spending adjustments ahead for both consumers and businesses in those countries, with the risk that such adjustments could become abrupt if currency crises develop.

Fiscal Policy as a Wild Card

One additional wild card for both commodity prices and the dollar will be U.S. fiscal policy. With some estimates suggesting that as many as 14 million U.S. homeowners will have negative equity in their homes by the end of the year, there is a debate underway in Congress about providing direct assistance to homeowners to prevent a destabilizing surge in mortgage defaults.

As noted above, market perceptions that the Fed is locked into an aggressive easing path have encouraged massive speculation in commodities. If the White House decides to endorse fiscal policy measures to provide direct assistance to homeowners – which could cost US$300 billion or more – we would not be surprised to see the dollar rally on expectations that the Fed will not have to cut interest rates again. That could go a long way toward dampening speculation in commodity prices, which have been viewed as a one-way bet on dollar weakness.

In short, there is the potential for a number of sharp reversals in several recent trends, although the timing is likely to be tricky. These trends include U.S. dollar weakness and related weakness in equities, especially financial stocks, as well as relative strength in commodity prices and materials, energy, industrial and emerging markets stocks.

How powerful these trend reversals turn out to be will depend crucially on decisions made in Washington in coming weeks and months. And that's one more reason for thinking of the current market environment as a Foggy Bottom.

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