Palisadian-Post Financial

DOLLARS & SENSE

Thursday, January 15, 2009 ◆ Pacific Palisades, California

Why This Market Rose Despite the News

By DAVID FRIED
Special to the Palisadian-Post

December was full of some of the worst economic news since the Great Depression. How has the stock market reacted to all the bad news? By going up about 18 percent since the low points in November and December!

Here's why:

While touting unemployment numbers in headlines, the media generally neglects informing their audience that, while the absolute numbers are high, they are comparing to a time (1980) that had a workforce that was 50 percent smaller. Also unreported was the news that productivity was up 2.2 percent in the third quarter. Rising productivity helps to keep prices down.

Also, the Fed acted aggressively in December to slash interest rates (on the money it loans to financial institutions) from 1 percent to 0.25 percent. The central bank said it expects to keep rates "exceptionally low" for some time to come, and also plans to expand its lending programs and purchase securities to keep the credit markets liquid. It also said it would use additional tools to help stimulate the economy.

Consumer prices fell in November by the largest monthly amount on record (dating back to February 1947). as energy costs posted nearly double the decline of the previous month. Prices fell 1.7 percent, surpassing the previous record decline of one percent set in October.

Since the early October sell-off, insiders have taken a long-term view and purchased their shares at an impressive pace. Insiders are normally predisposed to sell, but throughout 2008 insiders used any market retreat to accumulate their shares. That is long-term bullish, signaling that trading is at the area of a major bottom.

Insiders are buying because valuations are low. In 2000, investors were paying $6 for every dollar of book value in the S&P index. Now that number is down to $1.80 for each dollar of capital. That is certainly a better deal. Also, the S&P 500 now has a dividend yield of 2.9 percent, more that the 2.5 percent you can get on a 10-year T-Bill. If the market has a net return of less than 2.5 percent per year with a beginning yield of 2.9 percent, we are all in some trouble. The S&P yield has not been above the yield on the 10 year T-Bill since the mid-1950s!

Who'd a Thunk It?

Last summer, crude oil peaked at $147 a barrel and few people thought we would ever see crude oil under $50 again. The top of crude-oil prices was marked by congressional hearings and a prediction by the Goldman Sachs commodity analyst that oil would hit $200 a barrel by the end of 2009. Well, what no one thought possible has happened: crude oil has tumbled below $50 a barrel and the average gallon of gasoline is now less than $1.80 nationally. No one believed crude would lose $100 in value in such a short period. Economists estimate that gas prices at this level are the equivalent of sending $1 trillion in tax rebate checks to taxpayers.

Anyone Got a Match?

So what does the Fed mean when it says it will use additional tools? One thing it means is that it will create money. Over the past year the Fed has created almost $1 trillion as measured by money-supply figures commonly known as M2. Roughly speaking, M2 is the measure of currency in circulation, demand deposits, money-market funds, savings accounts, and time deposits. Add this to the additional stimulus created by the decline in gasoline prices (also about $1 trillion). Then add in the government loan and bailouts ($750 billion plus $100 billion plus for AIG) plus the rebate checks that were sent to taxpayers earlier in 2008, also totaling about $1 trillion. President-elect Obama has promised an additional stimulus package of about $775 billion, that will likely reach $1 trillion by the time it is passed into law.

This all adds up to about $4 trillion in stimulus sloshing around the economy in 2009. It is like spreading gasoline on the floor at a smoking lounge: sooner or later something will catch fire.

Financial markets tend to give us the unexpected. The markets and the public were convinced that ever-rising oil prices were permanent, but this has been proven wrong. Likewise, almost everybody is convinced that gloom-and-doom are surely to be with us for a very long time. Which brings us back to the beginning: Why is this market rising? The answer is fourfold.

First, the worst outcomes have been factored in by investors who are starting to think that we might not get these worst outcomes. Second, that all the news is not bad in spite of the headlines. Third, with all the stimulus "gasoline" circulating through the economy, something will ignite the economy (and inflation) sooner or later. Finally, by many measures stock prices are cheap.

Hopefully, the market will still be up (compared to the end of November) by the time you read these words. Markets will fluctuate and we are sure to see more down days. We may even re-test the October and November lows. In any event, I stand by my prior missive: "No time to sell" and I look forward to writing another "Who'd a thunk it?" about the market.

(David Fried writes The Buyback Letter, the only investment newsletter devoted to finding opportunities among companies that repurchase their own stock. His financial management firm, Fried Asset Management, Inc., is located in Pacific Palisades. Contact: 310-459-9196.)