Q1 2010 Market Commentary (Excerpt)

April 10, 2010 S&P500 Index 1194

More ominous to me is that speculators have aggressively returned to the same markets that were crushed two years ago – portfolio managers are bidding up bank stocks and insurance companies with talk of "normalized earnings" meaning that they think that all the bad debts and mortgage foreclosures have been written off and that earnings will go back to the levels they were at in 2006-'07, even though interest rates are rising, which will devalue the assets of these same banks. (Banks are huge owners of Treasury bonds and mortgages which decline dramatically in value as interest rates rise.)

Sensible people realize that earnings for most financial institutions cannot possibly get back to their prior peak levels as they have billions of dollars of ***less*** *capital, are now prohibited from leveraging up 20:1, 30:1 and more, and have had to issue millions of shares of additional stock to provide new capital. These additional shares of stock dilute the future earnings per share as follows: future lower corporate earnings are divided by a much larger number of shares of (common) stock resulting in a much lower earnings per share (EPS) and therefore a much lower future stock price!*

Some commodities like Sugar have reached all-time highs and many others like copper, crude oil, gasoline have screamed higher in price ***as demand for them has fallen and supply has increased!,*** the exact opposite of how you would expect a healthy market to behave. How could this happen? Because University endowments (i.e. Harvard, Yale, etc,) and State and Municipal pension funds are aggressively speculating by allocating billions of dollars to buy commodities, real estate, junk bonds and other illiquid "alternative investments" as though a huge economic boom was well underway. If this sounds like 2007-2008 again, you are correct. The same institutions and portfolio managers that behaved recklessly and irresponsibly from 2007-2008, and were directly responsible for the catastrophic crashes in the values of the portfolios they manage, are buying again, and no price is too high to pay for a speculative "investment".

I find all this greed and indifference to be VERY scary, as the optimism is increasing while the prices of everything are going up, with little mind paid to the reality that the ***discrepancy*** between asset prices and the actual state of the economy is greater ***now*** than at any time since 2007, the prior peak of the market!

If the trend of the past year holds, then we are likely to be very close to a short-term top, for now. With the Dow near 11000 and the S&P500 near 1200, we can expect some more buying this week into the options expiration (usually the peak for the market) and then I believe that unless Corporate earnings reports are truly spectacular, we will likely see a post-earnings market selloff similar to what we saw in July and October 2009 and most recently in January 2010.

This earnings period will be especially interesting since the crash of the US dollar in 2009 aided and artificially inflated the earnings of large-multi-national companies. Now that the dollar has been rising in 2010, which should act to depress the earnings of the multinationals, it will be noteworthy if the companies are still able to beat expectations, especially as the prices of commodities and raw materials and energy have dramatically increased this year. We will start to find out this coming week and, as usual, the market reaction to the news will be more important than the actual news itself.

While the stocks of small and mid-size companies continue to lead the market higher and the latest rally in the US has been echoed in Europe and Asia (all good signs), long-term interest rates have begun to rise around the world and speculation has increased dramatically in all types of illiquid investments even as banks refuse to loan money to profitable small businesses for purchases of capital equipment, machinery and other items necessary for business expansion. It is beginning to look a lot like 2007 all over again! It would seem that most of the financial decision-makers and portfolio managers have learned little, if anything, from 2007-2009.

I expect 2010 to be a good year for the stock and financial markets, but I also expect it to be a very bumpy ride, with the potential for violent and scary selloffs to happen at any time and for any reason. It will likely be a year of lots of market rotation into and out of specific industries, market sectors and countries.

It is important to realize that the large stock market rally of the past year, has been mostly a result of portfolio managers willingness to pay progressively more for the same $1 of earnings that they would have paid one year ago. As an example, if a company earned $1 in 2008 and in early 2009 a portfolio manager would only have paid $6 for that company's stock, in late 2009 they were paying $10 for the same stock and now they are willing to pay $12 for the same stock, even though the company is still earning the same $1. And that $1 of earnings has been artificially aided by 0% interest rates, corporate and personal tax credits to buy its products, ability to value assets on its balance sheet at favorable (and unreal) levels, and laying people off to reduce costs while making the "surviving" employees work longer hours for the same (or lower) pay and less benefits. While this looks good on government "productivity" and corporate earnings reports, it feels lousy for families as it damages their morale and confidence and hurts their ability to buy things.

In short, while statistically the economic expansion for companies has started, the stocks of companies have been bid up as though there has already been an all-out global economic boom! And while the same portfolio managers may be willing to pay higher and higher prices for that same $1 of earnings, it only means that stocks and other assets are becoming ever more inflated in price, with correspondingly less value!

Remember that ***"DOWN IS FASTER". It only took 2 weeks in January to wipe out the Sept. '09 – Jan. '10 gains!***

Copyright © 2009-2011 All Rights Reserved. RLS Financial Group, Inc.