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Fear and Other Pathologies

The stock market declined 9.4% over the past two weeks. During that time, there was no major piece of unexpected news. Fear and rumors dominated. That is not to say that the fears might not be well-founded, but it is important to recognize that a declining market does not prove those fears are accurate.

The Actual Data

The key events the past two weeks, all of which were unsurprising or brought better than expected news, have been:

- 1) The debt ceiling deal was reached the weekend of July 31. A deal was widely expected, and S&P futures on the CME were up 27 points Sunday evening.
- 2) S&P downgraded US government debt August 5. This was far from unexpected, as there was a senior S&P official said on July 19 that a downgrade might occur unless budget cuts in the debt ceiling deal totaled \$4 trillion (they did not).
- 3) New claims for unemployment, a key leading indicator, fell to their lowest level in four months and the four-week moving average has been trending steadily lower.
- 4) July employment rose a much stronger than expected 117,000, with a 154,000 private sector gain. This was the strongest report in three months.
- 5) July auto sales and retail sales were up solidly.

Less favorable, though far less significant, reports included:

- 1) The August ISM index was a disappointing 50.9. This minor release caused a minor panic.
- 2) The July trade balance rose more than expected, in part due to weak exports.

On balance, it is ridiculous to conclude that the value of major US companies should be worth almost 10% less on this collection of news. This is particularly true coming after second quarter earnings were reported up over 15% from the prior year and guidance for the second half of the year, while uninspiring, was hardly scary.

The Setting

The reports above don't tell the whole story, of course. The second quarter real GDP report, released Friday, July 29, was extremely disappointing. The 1.3% second quarter gain was pared with a downwardly revised first quarter gain of just 0.4%. That set a negative tone about the economic outlook, and understandably led to considerable talk of the risk of a "double-dip" recession. This set the stage for the fears to build on themselves, and for every piece of news to be interpreted in the worst possible light, even though the S&P 500 index only lost 8 points the day of the GDP release.

Second Half GDP Impacts

Interestingly, however, the strongest argument for a likely second recessionary dip seems to be that the stock market has dropped. That is, the stock market is down because of recession fears, and the talking heads on TV defend recession fears based on the fact that the stock market is lower. The circular reasoning gets lost amidst implications that the market knows something that is not evident in actual

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economic or earnings data -- all of which has apparently magically revealed itself in the past 2 weeks.

A mathematical look at the economic numbers, however, doesn't support the recession fears. The hard data indicate that third quarter real GDP growth is likely to be about 2% - still very weak but stronger than the first half of the year.

The weak-to-moderate trend of the past couple of years for economic growth continues. There is always a risk of recession, but the hard data released the past two weeks do not indicate anything that suggests the risk have risen.

The Downgrade

What about the downgrade of US debt? Wasn't that a reason to sell stocks?

An amusing aspect of the downgrade was all the personal-finance TV talking-heads. From CNN to local news, just about every "analyst" explained "what it means to you, our viewer" as follows: Higher mortgage rates, higher credit card rates, higher student loan rates, etc.

Wrong.

Treasuries ironically surged on the downgrade news as investors worried instead about a global recession. Bond yields fell sharply. Mortgage rates are trending lower and there is no reason to believe credit card rates will rise. Strangely, perhaps the only tangible impact of the downgrade will be -- LOWER GAS PRICES! Oil prices fell almost immediately following the downgrade news due to the recession fears. Oil prices have bounced back a bit since but remain lower. The downgrade by S&P will have almost no negative impact on the economic outlook, and might perversely produce a small positive impact on consumer spending through lower gas prices

So What is Happening?

The real reason for the sharp stock market sell-off is fear. The downgrade, following the poor GDP numbers, released latent underlying long-term concerns about the prospects for Western democracies. That may seem a stretch, but consider this week's cover of Time Magazine: The Decline and Fall of Europe (and maybe the West).

There are legitimate concerns about the impact of the long-term debt burden of the US government on the outlook for prosperity. There are legitimate concerns about the stability of European banks. There are legitimate concerns that the European Union is unsustainable.

There is, as always, risk. There is arguably more risk than normal. And given the experience of 2008, there is a tendency now to run from risk at the first sniff of any trouble, real or imaged. Last week, there were rumors of a run on Greek banks. Sell. There was talk of an Italian bank in serious trouble. Sell. No, wait, make that a French bank. Sell even more. It didn't matter if there was any data to back up the rumors, this is one of those situations where "everyone knows" the reality behind the situation - European banks are in trouble. So, the selling is deemed rational.

Paranoia and Greed are the Least of It

On top of what Benjamin Graham called Mr. Market acting petulant and throwing a fit for no other reason than bouts of fear, other pathologies have been exhibited.

The market has been absurdly volatile, as hardly needs to be explained to our readers. ADD, OCD, and manic-depressive would be diagnosed for an individual exhibiting such behavior. This is not a

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market efficiently processing information. Unfortunately, there are viable explanations. The proliferation of high frequency (black box computer) trading in recent years has increased volatility. The heavy hand of hedge funds in the trading of financial stocks is reminiscent of 2008 in unfortunate ways. The violent swings in the market, once started, are fed by the underlying fears and memories of 2008.

Sell in May

It is worth noting that fear is, once again, manifesting itself during the May-October period. Over the past fifty years, this period has produced the worst market downswings and none of the market gains. The gains have all occurred during the November-April period. "Sell in May and go away" is not just a pleasant rhyme. It is backed by decades of data.

July of last year, fears about Italy (or was it Greece, or Portugal?) caused a drop in the S&P 500 to 1025. By December, these fears were pushed aside by strong earnings growth (which also existed in the summer). This year the fears again have been magnified in the summer months.

What it All Means

Johnson & Johnson (stock of which your author owns) has, in contrast to the US government, a AAA rating. The company can issue 10-year debt for under 3%. Those proceeds could then be used to buy back stock that sports a dividend yield of 3.6%.

Think about that. Stock values are so low relative to bonds that management at JNJ could in theory do a buyout of all stock and immediately fund all the debt service by eliminating the stock dividend, and still boost cash flow 1.5%.

Conditions such as this are extraordinarily rare. These conditions indicate that stocks retain extremely low valuations relative to other investments. The earnings and dividend yields on stocks relative to bonds remain tremendously above historical averages.

The relatively high earnings yield on stocks relative to bonds doesn't mean stocks will rally in the near future. Problems and fears will persist.

There will be more European problems related to banks and to government debt. US economic growth could remain weak for a couple of years. It is unlikely that much will be done over the next couple of years to curtail the US deficit. Credit markets, particularly for real estate loans, still need time to clear. Yet, if Western democracies somehow manage to muddle through and survive, valuation will eventually matter. More specifically, if major multinational corporations manage to muddle through with earnings and dividends intact, their value will be undeniable.

Perhaps it won't be until November, when the focus might once again shift to actual data of earnings growth, balance sheets, dividend increases, and stock buybacks, that the hard cold cash of corporations will once attract attention.

Until then, the market could sure use a dose of Prozac.

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