

August 2009

"Getting Out of Equities"

The last few weeks have been as extraordinarily bullish for equities as the decline was bearish in 2008. This exponential run-up in equity pricing has coincided with equally euphoric declarations by many well-known strategists, news sources and opinion leaders. Investment banks, many of which were declaring the end of times just a few months ago, became increasingly bullish during the last few weeks. Bank of America / Merrill Lynch declared that the recession was to end in the second half and that it was bullish on global equities. Goldman Sachs was even more emphatic raising its SP 500 targets and referring to the current market as "the new bull market". It appeared as if all the closeted bulls were leaping out, trying to catch headlines and not be left out of the feeding frenzy.

Such declarations of bullish sentiment went far beyond investment banks. Moody's Economy.com stated that the "recession is winding down," former Fed chairman Alan Greenspan pondered that the economy could bounce back at growth rates higher than many economists expect, and Newsweek magazine pronounced in its cover story "the Great Recession ... is most likely over." Even Obama was recently quoted as stating "We may be seeing the beginning of the end of the recession."

Perhaps the most surprising statements came from a now well known NYU economics professor Nouriel Roubini. He gained the title of 'Dr. Doom' due to his bearish assessment of economic conditions prior to the downturn. Due to his accurate bearish call, the media has followed him quite closely during the last year. During the last month, not only has he stopped talking so bearish, but is actually calling for an end to the recession by year-end, asserting "there is now potentially light at the end of the tunnel."

In short, there has been an avalanche of bullish calls over a relatively short period of time.

The equity markets responded by appreciating more quickly than at most any other time in the last generation. For instance, the Nasdaq during July appreciated 12 straight trading sessions, a truly remarkable run. Additionally, after breaking this streak, it continued to appreciate – in other words, there was really no correction. Over the last month, from July 7 to August 7, the Nasdaq appreciated 15%. From its low on March 9, it has appreciated 58%.

In March, many of the aforementioned opinion leaders were not only bearish on equities and the economy but making reference to the then-current state as one similar to the Great Depression. In other words, at the low, they would have likely advised to take money out of stocks. Now, after a tremendous run-up in equity pricing, they feel comfortable enough to change their collective opinion to a bullish one!

To CR Investment Advisors, it appears a bit late in the game to be declaring a bullish stance on equities. **CR went bullish on equities in March**, at the low, advising clients that it was a good time to wade back into equities and that there was a strong probability for a large bounce in equity markets. We stated that economic conditions would likely soon bottom and that the equity markets would likely do well for a period of about six months.

Though possibly slightly early, we are taking off our bullish call on equities as of the release of this update. Equity markets globally have rallied almost non-stop since March with the weaker markets appreciating around 50% and the stronger ones approximately doubling. Though the expected economic bottoming process began more-or-less in-line with our forecast, the equity markets have discounted such news with lightning speed. Additionally, we are concerned that the avalanche of recent positive pronouncements is setting-up the equity markets for a let-down over the coming months.

When CR expected an economic bottoming process, most in the market did not. At the time, the equity markets were distressed, and most market participants were extraordinarily bearish. This created exceptional conditions to enter the equity market in March.

Now, it has become common market wisdom that the economy is bottoming out. Equity markets are no longer distressed, and many market participants appear schizophrenic due to their current overly bullish stance in comparison to what they were saying at the end of the first quarter.

Under such conditions, CR no longer feels comfortable advising long equity positions at present. The most bullish case we can imagine over the coming months is a sideways movement, in which case investors would be better off in lower risk instruments.

Furthermore, there are hints of resistance around current market levels which warrant a more conservative stance, even in the face of such a rapid run-up. The following chart shows the Nasdaq 100 index over the last three years.



Nasdaq 100 index over the last three years.

Currently, a fairly strong resistance line can be drawn from the 2007 peak, warning of a potential correction. The MACD indicator is also at a dangerous juncture. The fact that this indicator is rolling over and the price level is hitting resistance argues for a more difficult market going forward.

Emerging markets have been some of the strongest investments in 2009, and, therefore, deserve commentary as well. They have appreciated strongly and appear to be approaching resistance. The following chart shows the EEM, the emerging markets ETF, during the last five years.



The EEM, the emerging markets ETF, during the last five years.

Emerging markets experienced a period of euphoria during 2007 and early 2008, as many participants were calling for complete decoupling from developed markets. This period of extraordinary bullishness was marked by the accumulation depicted in the rectangle above. In order for the market to so quickly return to these levels, the conditions would have to be extraordinary. CR believes in the longer term case for emerging markets, but does not believe that economic conditions are strong enough for a return to these levels at present.

We will need to see significant improvement in macro figures for such a case to develop. Under this scenario, EEM appears to have very little real upside left – potentially ten percent more upside before significant resistance is hit. Such a return does not warrant staying invested after an approximate 85% appreciation in just five months. It is now time to take money off the table, relax, and reevaluate conditions.