Has the rally come to an end?

Stronger than expected payroll numbers. US markets rallied in the morning and fizzled at the close. A few weeks ago, this sort of better than expected economic indicator would have fueled a rally of at least 2% for the SPY and the Dow. What happened on Friday smells like distribution to me. The reality is that things aren't really getting better, ***they're just getting worse more slowly***.

I agree with Krugman, there is no V-shape recovery (http://www.bloomberg.com/apps/news?pid=20601068&sid=aATifebEMcHE&refer=economy). I think there is behavioural science angle to why the markets staged the recent sharp rally. 2008 was a shock. Very few people saw what was coming. In the abyss in Sep/Oct, many thought the whole US financial system was going to collapse. The rate of bad news grew exponentially, and many thought Armageddon was around the corner. Now the rate of bad news has slowed (which is viewed as good news in itself) and people have mistaken this for a recovery. Panic has been replaced by mere anxiety. This change in mental state makes people feel better. It's akin to losing 90% on investment but then making a 100% back. You feel better, but you're still losing a bundle. The fact of the matter is things are still bad. What would economists have thought if they were told the US unemployment rate would be 9.4% in 2009 back in 2007?

In the Asian markets last week, we saw the rally tiring. Markets rising earlier during the week, then falling and flatlining towards the close . More liquid markets like the HSI, running into serious resistance at the 19,000 level. The proverbial battle between the bulls and the bears continues. My guess is that the markets will probably sideways trade from here, with dumb money trying to buy on dips and smart money giving them stock at these levels, stopping the advance. It is true that certain markets are in bubble mode again, e.g. Hong Kong real estate, with lines of people queue in the rain for such crap projects such as "Lake Silver" in the New Territories. Hong Kong developers are taking advantage of this frenzy by putting up prices. The Lex column in the F.T. last week gives a good account:

> *It's like the crunch never happened.* ***Sino Land****, the fifth-biggest Hong Kong property developer, plans to* ***raise prices****at a sparkling* ***new complex*** *in the New Territories by up to 5 per cent. In five days of selling Sino has offloaded about three-quarters of the apartments on offer; the previous weekend an estimated 30,000 people had queued in* ***atrocious weather*** *to view them.*
>
> *This is a bona fide mini-bubble. The six big listed property developers have seen their aggregate market capitalisation more than double since October last year. Sell signals are blinking red: the trailing price/earnings gap between the property sector and the benchmark, which has averaged 200 basis points over the past five years, is now a mere 40. Residential property prices, meanwhile, have climbed back up to December 2007 levels; the recent peak, in March 2008, is a mere 15 per cent away. Hong Kong's banks, awash in liquidity, seem happy to respond to demand. According to the HKMA, total outstanding residential mortgage loans were up 1.3 per cent, year on year, in April, while overall lending shrank by 0.5 per cent.*
>
> *Over the long term, however, property prices have never decoupled for long from economic fundamentals. Prices and median household income are pointing in opposite directions. Unemployment may reach 7 per cent this year, from 5.2 per cent currently. GDP was down 4.3 per cent in the first quarter from the fourth – the sharpest decline in history.*
>
> *It is odd that Hong Kongers should be so in love with breezeblocks and mortar. Rental yields, falling since mid-2008, are near a two-decade low. Even with the recent lift,* ***nominal prices per square foot*** *are no better than where they were in January 1994 and more than 30 per cent adrift of the twin peaks they hit in 1997. A new generation of buyers should gird themselves for disappointment.*

What to lookout for next? For the moment I think the markets will trade sideways. There will be a trigger point when the markets will either continue their upward advance or reverse course. As one commentator put it a lot will depend if we face a severe inflationary/deflationary scenario.

> *Actually the scenario on equities depend whether your view in the near term calls for inflation or deflation. If you know which one wins then you should be able to properly assess your equity and bond exposure.*
>
> *In short, the S&P 500 should be below 666 by September and probably much lower by 2010 if the deflation scenario materializes so let's hope that the market is right and that we have stagflation.*
>
> *The recent rally has been fuelled by a massive injection in liquidity by the central banks around the world*

*and investors are expecting higher as a resul
t of the inflated FED balance sheet.*

However, where I think the market is wrong and this is why I have remained so bearish lately (not because I want it but) is the velocity of that money supply is nil. Banks are simply not lending money. Therefore, the mass of money is staying in the FED and banks balance sheets but is not flowing into the real economy.

The consequences are: the deflation will remain the biggest threat and deleveraging will continue for consumers and corporates. Once the market has realized that (and I may be a bit early in my call but who knows how to time these things) then they will fly back to safety which means buying US 10 years treasuries and selling equities. My gut feeling (for that is worth) is calling for the market to double bottom by September.

If you want a similar period of reference you have to look at the depression of the 30s or the big recession of the 1870s. You can’t compare the current recession to the 90-91 or the 70s because they were different animals.