Recovery or Bear Market Relief Rally?

For those of us who have lived through major bear markets there is significant skepticism about the current equity market rally.

Reasons to be optimistic:

- Economic data is improving. The extreme inventory destocking in late 2008 is being reversed. Housing prices are stabilizing. Housing transactions are rising.
- China as an engine of growth. For now domestic consumption is muted and savings rates are too high but the infrastructure spend will boost growth.
- Emerging Asia and Lat Am is replete with healthy companies at distressed valuations.
- Markets have overshot on the downside and are exceedingly cheap.
- Equity earnings yield gap is supportive of equities.
- Government policy is extremely supportive of risky assets. And will continue to be until asset prices recover. TARP, TALF, QE, PPIF and so on.
- The legacy loans program
- Markets turn a good 12 months before the real economy recovers.
- The market panic is over, investors are recovering from the initial panic.
- Inflation will be positive in diminishing the real value of debt and encouraging consumption.

Reasons to be pessimistic:

- TARP. TALF, PPIP, et al won’t work, or at least not as well as intended. The plans are short on detail but long on principles. There are a number of ways the plans might fail, some high probability ones. The government has now provided the capacity to purchase distressed assets from banks. They have not addressed the propensity for banks to sell. The market will likely remain thin and illiquid. The process will take too long.

- Credit markets may be functioning again but the demand for credit is also diminished. There are mixed signals here. Companies are looking for credit to refinance existing debt and the recovery in credit markets is positive for them. Households will benefit from the Legacy Loans Program. The propensity to consume, however will take time to recover.
- There is a crisis of unemployment which will take longer to resolve. The problem is global and likely to be protracted.
- Economic problems become social order problems. Pockets of unrest have arisen in France, Eastern Europe, China.
- The perma bears are waiting to short at around current levels.
- Inflation may become a problem. So far expectation for deflation have not come true. In fact there are incipient signs of inflation.

It is always too early to tell if the market will recover. It is only knowable when the market has already recovered.
Most analysts are graduates with a straight ruler. They are quick to connect the line between two points and extend it indefinitely.
Different analysts have rulers of differing lengths.

My best guess is that the current rally may continue for another month but runs out of steam (1st quarter results are not going to be pretty), equity markets make new lows in 2H 2009 and then we have a real recovery. Why? I think we have had the panic selloff and it lasted from September 2008 until March 2009. We are currently experiencing a relief rally. Such rallies can be quite strong. However, I do believe that the real economy still faces considerable problems which will take time to resolve. Equities are forward looking and should price a recovery a good 12 months ahead. I simply don’t see a sustained economic recovery before the latter half of 2010 or early 2011. This would put a sustained recovery in equity markets at late 2009 to early 2010. Remember, this is a best guess. Would I trade on it? Ask me every 3 days.

Now equity markets lead recoveries but credit markets don’t. So, now, what was that about wanting to invest in distressed credit again?