

Bull, Bear or Chicken? Mid-Year Market Forecast

Most stock market indexes are up in the neighborhood of 7-8 percent year to date and almost 25 percent for the trailing twelve months. Against this backdrop stocks have become more volatile of late, going up or down as much as 1-2 percent in a day.

This record of above average gains coupled with higher rates of day-to-day changes may be suggesting the market is at some sort of inflection point. Historically when market volatility increases after a long period of stability, there is an 85 percent chance for a correction to the downside and a 15 percent chance of a strong upside. Given the age of this stock market advance it would seem the odds would favor a downside correction to a break to the upside.

But what kind of correction and for how long? Again, history tells us that the current stock market is not significantly overvalued by historical standards. There is little in the way of items that would suggest a sharp and sustained downturn. Investment funds continue to be available. Credit is becoming more expensive but is available. These factors would argue for a correction of small magnitude and relatively short duration.

What may be surprising in coming months is not the existence or absence of a correction but the contrasting performance of various industry groups. Financial stocks of various categories have as a group underperformed the overall indexes since the first of the year. This is in spite of the fact that this group of stocks represents the largest sector of the market by capitalization. When the largest sub-group underperforms the overall group's performance then other groups must be performing far better than the averages. So far this year basic materials, manufacturing, agriculture, and capital goods groups have all outperformed the overall market.

The essential question to ask about investment data is whether the trend will continue and if so for how long. It would appear the strength in the above sectors is more the result of foreign demand than domestic. For this reason these sectors are not caught up in the current unfolding correction in the housing market. They represent the fact that the rest of the world is currently growing faster than the United States.

This trend shows evidence of sustainability. Since 2000 over a billion people have improved their lot in life to the point of being classified middle class in their respective countries. This economic improvement which free trade brought about exceeds the number of beneficiaries from all public and private foreign aid programs since the end of World War II. It is also the reason the world can continue to generate growth even when the United States slows down.

Accompanied with this trend of economic growth is a rising rate of inflation. As countries become more affluent demand for goods internally increases. Diets are improved with the addition of more protein. This increases the cost of meat all over the world. New middle class consumers want middle class trappings such as better housing, auto transportation, and leisure options. All of these factors translate into increased demand for foreign goods.

What could end this fortuitous chain of events is the same thing that ended the economic expansion of the 1920s. The demands for protection of domestic industries and employment can result in more restrictive international trade which in turn reduces economic growth. With less foreign demand for US goods and resources the economy of this country would slip into a recession.

Were the political situation in the US more stable the future would be more predictable. The current leadership favors the expansion of international trade for the reasons and results outlined above. Unfortunately the current leadership has spent its political capital on ventures where the return has not been to date that great. As a result it has little influence on the current course of economic events.

The political quandary is that the benefits of trade are significant but dispersed. The victims of trade are few but concentrated. The victims are, due to past institutions, better organized than the beneficiaries. Thus they have a greater political presence.

While it would seem that cooler heads and the status quo will prevail, it is not a given. Thus the need to qualify forecasting the financial future. If trade is maintained the US and world economy can continue to advance. If trade is impaired that advance will be called into question. This may be considered a chicken economic forecast. So be it. Better to be a live chicken than a dead duck.

The Economy

In spite of all the doomsday talk about the real estate market, the economy has continued to chug along. This is due in great part to the demand abroad for US goods mentioned in the previous section. It is also due to the fact that all housing markets are local. Excesses in one market typically do not impact the price or activity in another market unless the markets are very proximate to one another.

Looking ahead, it would appear that international demand will continue to impact domestic economic activity. As consumer spending plateaus and the federal deficit declines, it will be up to export demand to drive the economy forward.

Interest Rates

One current misperception is that the Federal Reserve is setting interest rates. While technically correct, they are being significantly influenced by the rise in interest rates elsewhere, especially England and Continental Europe.

The reason domestic interest rates must be competitive with the rest of the world is that were US rates too low, foreign investment would flow out of the US to higher risk-adjusted yields elsewhere. This would cause the dollar to fall sharply relative to other currencies which would encourage inflation.

For this reason it would seem that current interest rates will remain stable at least until year end. If there is continued interest in raising rates abroad the surprises at home will be on the upside.

Inflation

Inflation data is due to accelerate. Already egged on by food and fuel prices, the increase in the minimum wage will have a significant impact on the inflation computation in a way that cannot be explained away in the manner currently deployed.

A higher inflation rate will be politically destabilizing in ways that will not lend themselves to a political solution. We appear to be entering an economic environment not unlike the late 1960s/early 1970s. This will have significant impact on the economy, savings and spending habits.

The Stock Market

While arguments such as those made earlier will characterize the stock market near term, it is perhaps of greater import at this stage to be aware of the shifts in various groups and stocks within the market.

While one can “buy the market” in the purchase of index mutual funds, superior performance consists of finding the sectors and companies that will outperform the overall market over time.

There does seem to be a shift in groups going on. It seems to be an acceleration of the shift that has taken place since earlier in the year. While these groups do seem likely to prevail, they may be affected by any market correction that comes along unannounced. It is assumed at this point that emerging groups will not go down as much and will increase more going forward.

Examples of such groups would be rail transportation, manufacturing, capital goods, energy services, and non-residential construction.

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