

0.01 Percent: Why Stocks Will not Retreat Any Time Soon

Recent data from the money market fund industry disclosed that 87 percent of money funds in the US are currently yielding 0.01 percent per year. This amount is so statistically insignificant as to be symbolic.

The reason for the yield has to do with the low returns on assets that money funds invest in. At this time three-month Treasury bills return 0.08 percent. Corporate returns for this time frame are not much higher. This means that money market mutual funds have had to reduce their fees to offer even the token 0.01 percent rate.

Investors have reacted in predictable fashion by incurring more risk to get returns in excess of the inflation rate (realistically around 2-3 percent). Year to date, bond mutual funds have outsold stock funds by a 20 to 1 ratio. Such purchases have been the main reason the high-yield bond market category returns have outpaced the stock market this year by a factor of almost three. At the same time US Government bond funds have declined by anywhere from 5 to 15 percent, reflecting the unwillingness of investors to accept low returns now that the financial crisis that began a year ago has subsided.

Some of the individual investor funds have found their way into the stock market. More will do so before this credit cycle is over. As interest rates on corporate paper decline investors will again have to accept appreciation potential as part of their return equation.

So far most investors have been out of the market. The market returns to date have benefited for the most part the investment professionals and their clients. The typical individual investor was too scared in the aftermath of the meltdown from September 2008 to March 2009 to get back into the market.

This development has several implications. The first is that individual investors will most likely be the force to drive the market higher. The second is that heavy involvement by individual investors will likely be the last stage of the market rally. After all, who will be left to buy from them? The third implication is that the rally will not reverse until either short-term interest rates again rise above inflation or valuations become stretched relative to economic prospects.

Rising interest rates will be engineered by the Federal Reserve in time. Until then the current liquidity strategy of the Fed insures low short-term rates. While individual investors are hurt by the low rates, the banks find such rates to be a windfall. Indeed the spread between the average cost of funds by the typical bank and its loan rate is among the highest on record. While some of this wide spread is being used to fund losses on loans, the rest is resulting in higher bank earnings which essentially build up bank capital.

The initial recovery will be driven by inventory restocking. As companies draw down inventory to reduce bank lending and working capital, at some point sales are not made due to the absence of product. As orders are given to order more than is being sold inventory is replenished and economic activity picks up in the process. The act of hiring more workers for the higher level of production generates jobs which in turn drives more demand. Economists refer to this as the virtuous economic cycle.

This pattern is already evident in the auto industry where the cash for clunkers program has left most dealers with a 28 day supply of autos when the normal inventory levels would be 55-60 days supply. For the next two quarters auto production will exceed auto sales in order to replenish dealer lots. Since autos contribute to the economy when they are built as opposed to when they are sold, this trend should help lift the economy out of the recession.

In some parts of the country a similar trend is evident in housing. While no means universal, in some areas housing demand is strong for properties priced \$250,000 and under. Such activity will contribute to the economic revival in store for the next two quarters.

After six months of inventory replenishment the economy will need to have an encore to move forward. This will hopefully take the form of foreign demand for domestic goods and services. The traditional source of incremental growth, consumer spending, is not expected to provide leadership in the next economic cycle. To date most consumer savings has taken the form of debt reduction. This is rational as consumers effectively get a greater return by paying off loans than they do in cash. Once cash returns increase to attractive levels more conventional savings will begin in earnest.

The Economy

The economy is poised for a rebound over the next two quarters for reasons described. The issue is the rate of growth to be expected thereafter.

Much will depend on foreign trade. This will in turn depend on such factors as the weather for farm exports to a cheap dollar in the case of manufactured goods. There seems to be a sense that US made goods can hold their own in a free trade environment. However one factor is the cost of the tax on energy which is more present in the developed world than the developing countries.

Inflation

A branch of economics called monetarism tends to see the revival of inflation in the high numbers for the Government debt as well as the stretched balance sheet of the Federal Reserve. In essence monetarists believe that the volume of money in circulation causes inflation irrespective of demand for goods and services. More extreme monetarists advocate tying the volume of money in circulation to something like gold to prevent its growth faster than some finite amount.

In reality total domestic debt outstanding is growing little if at all. The increase in Government debt is simply offsetting the decline in consumer debt outstanding. Were this not the case the contraction in credit would set off a decline in prices reminiscent of the early 1930s.

The large Federal deficit will contract with both economic activity and higher taxes. While no one discusses taxes at this time, the elephant in the room is the Bush tax cuts which are set to expire over the next few years. By simply letting them lapse there would be a tax increase without legislative action.

Interest Rates

The current interest rates are slated to increase but not by enough to impair the recovery. The banking system needs all the profits it can get to offset losses on residential and commercial mortgage loans.

A “rational” interest rate would be somewhere around the inflation rate for money market funds and a bit higher for 1-3 year investments. However, such rates are not expected to be seen for a couple of years at least given the projected pace of the recovery.

The Stock Market

One is struck by the low level of public participation in stock investing in spite of the 50 percent rise in the general indexes since early March. The roller coaster ride of last year is still fresh on most investors’ minds. In addition, any number of investors have real losses to look at after selling at the bottom when the cable channels were telling them to.

Collective memory is not that great or that long. With returns on most bond investing now dropping to levels that offer not much more than cash flow going forward, it will soon be time to compare stock returns to bonds and find bonds wanting. While bonds as a group have lower risk than stocks as a category, most investors do not assess risk when evaluating returns. If investors did account for risk most of the hedge fund industry would disappear.

While the flow of funds into stocks is slated to increase, the flow into which stocks will be an issue. With a forecast for slow economic growth after the initial bounce, valuations will be equaled or exceeded more quickly than in a more pro-growth environment. This makes discrimination in stock selection paramount. A market with little conviction tends to be one of great volatility.

In the short run there is a chance of a correction in financial shares which have seen a run-up over twice the market from its lows. As much as 20 percent of daily volume is concentrated in such shares, whose prospects have not improved enough to justify the stock prices. As this correction takes place other sectors should assume market leadership going forward.

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