

The Building Blocks of the Next Bull Market

By Robert Huebscher

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A bull market requires three things – attractive valuations, excess liquidity, and strong economic growth. Two of those three appear to be in hand, and the third, economic growth, may soon follow, Louis-Vincent Gave said recently.

Gave is CEO of GaveKal, a Hong Kong-based economic consulting and fund management firm. His remarks were delivered at the Altegris Strategic Investment Conference on April 3.

Based on common metrics such as P/E ratios and market capitalization as a percentage of GDP, Gave says US equity markets are “at least close to historically low levels.” Gave was similarly confident that sufficient liquidity is present to fuel a bull market, a judgment he based on money market and cash balances.

But economic growth is the key impediment to a sustained market rally, Gave said. GDP historically has grown at approximately 3% annually, and growth was basically at this normal rate over the last four to five years. GDP growth rates advancing significantly above the 3% trend line are a reliable leading indicator of an impending recession.

The current recession, however, is the exception to that rule, and this distinctive characteristic creates the critical challenges to recovery.

The big problem is that lending is still at a standstill, principally because banks cannot securitize their loans. In the current environment, banks can buy loans at 80 cents on the dollar in the open market, leaving them with no incentive to originate loans.

The government’s response, through the TALF program, is an attempt to increase the values of loans in the secondary market from 80 to at least 95 cents on the dollar, which will indirectly stimulate lending. “It may work,” said Gave, “but you also need consumers willing to borrow.”

Consumer interest payments currently represent approximately 15% of income, which Gave says is near record levels, and he believes this, combined with a bottoming out in the real estate market, can restart lending and consumer spending.



“If lending gets going, auto sales will follow,” Gave said. A lot of the loans being repackaged and sold through the TALF program are auto loans, he noted, consistent with the Obama administration’s policy of stimulating auto sales.

“We will know whether the US is mending from the credit markets, and the credit markets right now are not buying into current equity market rally,” Gave said. Spreads have not tightened. BAA corporate bond spreads below 5% are critical for an equity market, and they remain near the 6% level. “The credit markets are saying that debt can’t be rolled over, and that debt will eventually become equity,” he said.

While the TALF program represents one way out of the current crisis, Gave said another path offers similar potential – growth from China.

“In 1949, people said Communism would save China, then in 1960s they said the Cultural Revolution would save China, and a decade ago the mantra became ‘capitalism will save China,’” Gave said. “Now the question is whether China can save capitalism.”

China’s problems do not stem from a collapse in its exports. “For China, exports are the cherry on the cake – most of China’s growth is from domestic capital expenditures and domestic consumption,” he said. Only 2% of Chinese growth comes from exports, whereas 10% comes from those domestic sources. “Those two percentage points are gone,” Gave said, and its absence is forcing a massive inventory cycle adjustment.

Meanwhile, Chinese real estate has undergone a brutal collapse caused by inflation and rising commodity prices. “Chinese consumers are traumatized and squeezed, and the Chinese government is using excess savings to buy commodity assets worldwide,” he said.

Gave said this is bullish for China. China has made deals with Russia and Saudi Arabia to secure long-term supplies of commodities, and these deals take away a big inflation threat.

What is bullish for China, however, will be bearish for commodities. Commodities historically go through 20-year cycles that end when supply shortages, price spikes, and reinvestment eventually bring prices back down to the marginal cost of production. “Commodities are not a good structural investment,” Gave said.

Chinese consumer spending has stopped, in part because the Chinese are saving for education and health care costs. For that reason, China’s stimulus bill provides for 95% health care coverage over the next five years. “This will stimulate consumption,” Gave said. “Consumption will be very different from patterns in the US, where the people have 600 square feet of living space. The Chinese have only 100 square feet.” Consumption in China will be geared to services and small goods, he said.



If you are willing to bet on growth in China and elsewhere in Asia, the best asset class is real estate, Gave said. He sees pent-up demand, which, along with low interest rates and rapid money supply growth, as good news for real estate investors.

According to many, Japan is the basket case of the Asian markets. Gave, however, likes the opportunities in Japan, because its government is “finally killing off the zombie companies,” facilitating long-overdue rationalizations across many industries.

Eastern Europe is a principal source of worldwide risk, according to Gave, following the unprecedented boom in the region. “When capital flows get to be 6% of GDP, we need to worry, and those flows got to 12% in Eastern Europe,” he said. Western European banks lent money and that debt now cannot be refinanced. “This is a typical emerging market crisis and will end in a massive collapse in currencies, in order to attract new capital,” he said.

Most European currencies are not yet undervalued and need to fall another 30-40% to be cheap.

What does this mean for US investors? What many don’t realize, Gave said, is that Eastern Europe has a comparative advantage in the automotive sector. “Eastern Europe is extremely good at producing cars,” Gave said – not the news US automakers want to hear. European companies that can outsource production to Eastern Europe will benefit, and the losers will be those who compete with them.

Gave said the European Central Bank (ECB) is not likely to help Eastern Europe refinance its debt. “Half of the ECB Board, led by Germany, has no interest in bailing out weaker European nations,” he said. The Euro was conceived as result of a political compromise by France and Germany. France didn’t want Germany to dominate the region, so Germany gave up the Deutschmark and agreed never to have a German head the ECB. The Bundesbank was stabbed in the back, losing its clout. Today, the Germans see the opportunity to return to a new natural order, and that is why they raised interest rates. The Germans are saying “Get this dog off my leg!” in regard to problems faced by Eastern Europe, Gave joked.

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