December 04, 2008

Are We There Yet?

It's a phrase guaranteed to curdle the blood of even the most level headed parent. It's also one that we can't stop asking ourselves about this market and the economy. Is there more bad news out there? Will stocks continue to fall further? Are we headed for the second Great Depression? Never a great student of history in school, it is times like these that I have come to appreciate the importance of history in providing valuable insight.

I pulled out one of my favorite charts recently. It is a "mountain chart" – a line graph that depicts the path of the stock market since 1929. This particular one has dates superimposed on the graph highlighting significant events of our past. Scanning this document I'm always impressed by the important, and life changing happenings in the last 80 years; from the various wars we were (are) a part of – WWI, WWII, The Korean War, The Cold War, Vietnam, Iraq, to significant political events – the Kennedy assassination, Watergate, Abscam to other world changing events – the Berlin Wall, Sputnik, the Cuban Missile Crisis, Oil Embargo, Nine Eleven.

Although it is tempting in times like these to think we've never been here before, the fact is that we have. Although the current "crisis" is significant, it frankly pales in comparison in my mind to the devastation in human life, and the human psyche wrought on September 11, 2001. And through it all, looking back on my chart, we as a society and a financial system have prevailed. I have no reason to doubt that this time will be different.

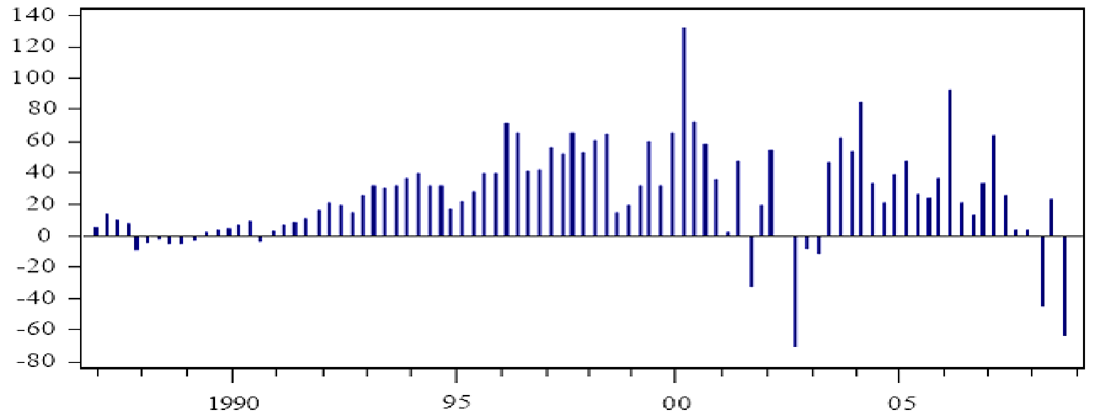
There has been a significant amount of chatter about the coming second Great Depression (GD2). Not only is this talk misguided, it certainly doesn't stand up to any scrutiny. Although some of the same factors brought us to this point as in the past: loose lending standards, real estate speculation, high levels of debt, this is where the similarities begin to break down. Many of the safeguards now in place (FDIC insurance, SIPC insurance, bank leverage ratios) were a direct result of the failures of regulatory authority back in the 1920's. In addition, we now have, and are willing to use tools not contemplated back then (The Federal Reserve Bank, The US Treasury) to reinvigorate our economy.

You may have heard that, *surprise*, we have been in a recession since late 2007. If history holds, the average recession lasts 12-24 months. I believe we will most certainly be on the longer end of this range, but even at the long end we may be about half way home. Remember also that markets recover before the overall economy does. The stock market began a significant rally in 1934 even though the economy didn't recover fully until the post World War II expansion that began in 1945.

Besides my trusty mountain chart, another data set that gives me great confidence tracks the flows of money into or out of equity (stock) mutual funds and compares this to equity fund performance. Although the mantra "buy low, sell high" is on the lips of most investors it apparently stays there, not able to penetrate the collective cerebral cortex. There have been a number of times in the recent past where significant amounts of investor money have flowed into, or out of the stock market. These flows have been good predictors of market direction – as long as you go the opposite direction.

Figure 1. Net Cash Flow into Equity Mutual Funds

New fund sales minus redemptions for all US equity funds, quarterly data, billions of USD

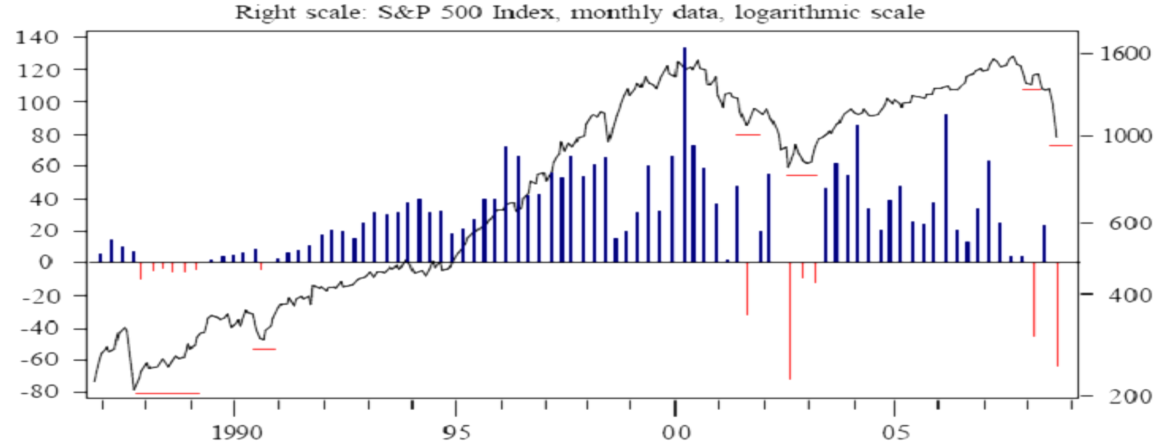


These charts are from the Capital Observer: www.capitalobserver.blogspot.com/2008/11/equity-mutual-fund-flows-and-uncanny.html. The chart above tracks the net flows of money into or out of equity mutual funds. Bars above the zero line (on left) indicate net inflows of investor money into mutual funds; those below zero indicate net outflows. Although this data is interesting on its own, it doesn't really tell us much until we add another data set – the direction of the stock market.

Figure 2. S&P 500 Index vs. Cash Flow into Equity Mutual Funds

Left scale: mutual fund quarterly data, billions of USD

Right scale: S&P 500 Index, monthly data, logarithmic scale



Note the accelerating inflows of money in 1990, 1993, 2000 and 2007. At each point, these inflows marked the top of that market cycle (black line) for the S&P 500. Look at the net outflows (in red). Note that previous equity mutual fund outflows occurred in 1988, 1990 and 2002-2003. Note that these outflows signaled the bottom of those market cycles. There have been exceptions to this pattern (see 1996 and 2003 where rising inflows matched a rising market and in 2008 where there was no significant increase in inflows marking the market top), but on whole this has been a pretty decent contra-indicator of market direction. We have experienced significant net redemptions in the months of September, October and November (only September is shown above) in 2008. I would expect that these redemptions will eclipse the 2002-2003 period by a wide margin. If there is a better picture of what fear and greed looks like in the stock market, I haven't seen it.

So, are we there yet? You know the words. Say it with me. We'll get there when we get there.

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