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The Teflon market

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Stocks recently enjoyed their best first quarter since 1998, and begin April on an upbeat note. For the first quarter of 2011, the Dow closed up 6.9 percent, the S&P 500 was up 5.95 percent, and the NASDAQ was up 5.15 percent. Those are strong showings in the face of continued uprisings in the Middle East, rising prices for oil and commodities, and the Japanese earthquake and tsunami.

The market, dubbed by some as "the Teflon market," just kept rising in the face of bad news. Volume was steady, if not spectacular – a sign that the market had not entered a frothy stage. Indeed, retail investors have not yet become excited about the market, which reached its highest levels in three years.

Traders are unwilling to bet against the market. Short sellers had the lowest level of loans against stocks sold short in five years. The ratio of long bets on the market to short bets is near a six-year high. Hedge funds are less willing to take the short side against a rising tide.

Bond funds continued to experience outflows, while some bond funds slipped into negative territory for the year to date. Readers and clients know that I have been encouraging the reduction of exposure to bonds for some time. I see no reason to change that position, particularly as Fed futures are betting on a rate rise by the end of the year.

Surely the massive intervention in the markets by the Federal Reserve not only stemmed the downward trend, but aided in the recovery. Quantitative easing – an effort by the Fed to buy bonds, and keep interest rates down – supplemented record government spending to buoy the economy.

The record low interest rates have aided the economy even as banks face fresh scrutiny for their lending practices. Low interest rates also weakened the dollar and pumped up the manufacturing sector all over the U.S. and the globe. Stronger manufacturing activity in the U.S. was especially welcome in the Rust Belt, and the White House.

In March, employment rose by 216,000 jobs – that is still below par, but it's a welcome relief to the numbers we have seen for years. The official unemployment rate fell to 8.8 percent from 9.8 percent in November, but of course these numbers do not count those who are underemployed or who just quit looking for work. Indeed, we are still 7.25 million jobs off our peak.

The rise in prices of oil and other commodities put additional pressure on consumers and manufacturers. Nevertheless, projected earnings for the first quarter, which will be released over the next weeks, are forecast to grow about 13 percent for the S&P with materials, energy and industrials leading the way. Utilities and telecoms are forecast to be the laggards. Even consumer discretionary earnings are tipped to grow nearly 10 percent.

Higher gasoline prices are encouraging people to look for housing closer to their jobs. Schools still matter, even while school financing suffers. Probably the best correlation to a home price is the quality of a local school district. The finances of local schools and parks may be more intertwined with Americans' finances than they think.

There is still a long list of problems from the Middle East and the Japanese crisis that need to be resolved. The most obvious fallout from the Middle East will be higher oil prices, which will affect the overall economy and the consumer specifically. The Japanese crisis could lead to a repatriation of yen and liquidation of Japanese investments around the world. This has not happened yet; however, the yen did appreciate dramatically in anticipation of these events. A concerted effort by the Japanese and other central banks against the yen brought its value down.

Questions have arisen about the ability of the Japanese to continue servicing their national debt. However, the Japanese have no choice but to make good on their bonds because most Japanese bonds are owned by the Japanese government and "Mrs. Watanabe" – in other words, they owe it to themselves.

In earlier columns I have opined that a government that owes its debt to itself and its citizens does not default. The Japanese government over the long term will have no choice but to continue to buy Japanese bonds, in a sort of perpetual quantitative easing, because citizens are old and getting older. The government is losing buyers to death; they are not being replaced as the Japanese population shrinks and survivors become less inclined to buy government bonds. Young Japanese citizens are deferring marriage and children. Rumor has it that more diapers are sold in Japan for elderly people than for babies.

For years Japan has had the world's largest deficit in comparison to its GDP, but under the current administration, the U.S. has overtaken the top spot. In fact, the U.S. now leads all advanced, emerging and low-income countries for percent of debt relative to GDP. That certainly isn't a No. 1 to be proud of.

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