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Market Outlook

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Oil prices soared to a record $147/barrel in July on the same day the stock market recorded new lows on the year. As oil retreated nearly 17% from those highs in the days that followed, the stock market responded with an impressive recovery led by the financial sector. The Dow Jones Industrials (+.25%) and Nasdaq Composite (+1.4%) ended the month with modest gains, but the Standard & Poor's 500 (-1.0%) finished the month with a modest loss. Financials led sector performance with a gain of 6.8%, while energy was the worst performing sector, posting a loss of 14%.

> We can't blame investors for being disillusioned about what has become a high stakes Monopoly game, but we believe those not swayed by the emotional herd are about to receive a Get Out of Jail Free card and evict the market manipulators from their roost on Park Place at the same time.

It was no coincidence that the decline in stocks converged with a new all-time high in oil. When oil prices go up, stocks go down, and when oil prices go down, stocks go up. It has been as simple as that for some time. What sent the stock market, and financial stocks in particular, plummeting well below their January and March lows was yet another chapter in the never ending saga of market manipulation.

Selling a stock short is a common tactic whereby an investor places an order to sell a stock he does not own. The investor then hopes the stock declines so that he can repurchase it at a lower price and book the profit. Regulations require that the investor borrow the stock from an existing shareholder who is willing to lend it before executing the sell transaction, and return the shares after buying them back. Naked short selling is an illegal practice whereby an investor or institution places an order to sell a stock without ever borrowing the shares. It is not difficult to understand how much damage an unlimited volume of sell orders can do to a particular stock or group of stocks. The financial sector was victimized by such an onslaught until regulators announced a temporary ban on this practice for a select 19 financial companies. The very next day, on July 16th, financial stocks soared and the stock market followed. Oil simultaneously began its steep decline.

Please do not ask us why regulators would temporarily ban an already illegal activity for just a handful of stocks. It is quite obvious that naked short selling has been a common practice among Wall Street brokerage firms, at the behest of their best institutional clients, for a very long time. It simply reached a point of anarchy similar to the episode in March that led to the demise of Bear Stearns.

We have outlined for several months the various forms of speculation and market manipulation that have infected the equity, fixed-income and commodity markets like a constantly mutating virus. The weapons of financial destruction used in this endeavor include credit-default-swaps, commodity futures contracts and now naked short selling. A lack of regulation and oversight has paved the way for this abuse. We believe these collective activities have resulted in nonsensical market prices for all asset classes (stocks, bonds and commodities), leading most market participants to the false conclusion that these distorted prices reflect a grim reality. We can't blame investors for being disillusioned about what has become a high stakes Monopoly game, but we believe those not swayed by the emotional herd are about to receive a Get Out of Jail Free card and evict the market manipulators from their roost on Park Place at the same time.

Tops and bottoms in the stock market are typified by relatively short periods of time when perception could not be further from reality. Everything in between is a gradual revision to the mean, like a pendulum swinging back and forth. These inefficiencies in market prices are what present investment opportunities. Warren Buffet once said, "Be greedy when others are fearful, be fearful when others are greedy." We know fear is in abundance, so it must be time to get greedy, keeping in mind that short periods of time are defined by months and not days.

The major crisis this stock market now faces is one of confidence. The television and print media, as well as the majority of market pundits, continue to fan the flames of pessimism. Where were these bearish forecasts in the summer of 2006 when home prices were peaking, or in summer 2007 when the mortgage meltdown began to unfold, or in January 2008 just before the credit crisis reached full tilt? We hate to disappoint those who continue to wallow in despair and embrace the most negative of market and economic outlooks, but the glass is half full, not half empty.

There is light at the bottom of the housing market abyss. The rate of monthly declines in home prices has slowed for three consecutive months. The volume of subprime mortgage rate resets will decline dramatically this fall. The number of unsold homes has stopped rising and new listings now match demand for the first time since 2005. The rate of new mortgage delinquencies has fallen for several months, and we have yet to see the impact of the new housing bill just signed into law by the President this week. This is improvement!

The economy grew nearly 2% in the second quarter, thanks to strength in capital spending by corporations, trade and consumer spending. This was an increase from less than 1% in the first quarter. Growth will remain sluggish, but this is not a recession. Consumer confidence actually rose this month from a 16-year low for the first time this year. We expect the November elections will result in a further boost to confidence, regardless of the outcome, based purely on the fact that the Bush administration will be gone.

Inflation is now the greatest obstacle to higher stock prices, and the price of oil is at the core of our inflation problem. The Goldman Sachs commodity index is up 70% year-over-year, matching the peak reached in 1973. The result has been a slowdown in global growth, which we expect to bring down commodity prices, led by oil. As the price of oil declines, so will the rate of inflation. This will allow the European Central Bank to lower its short-term interest rates, which will in turn strengthen the dollar and put further downward pressure on oil prices. This will ultimately lead to higher stock prices as corporate earnings continue to grow, albeit at a slow rate, but valuations increase. A lower inflation rate reduces borrowing costs, improves operating margins and increases consumers' purchasing power. This is the key to the market recovery.

We believe the financial and technology sectors will emerge as performance leaders in the second half of the year at the expense of the energy, industrial and materials sectors. We see no change in the 2% Fed funds rate until next year, as economic growth remains sluggish and the unemployment rate continues to rise modestly. The alternative energy sector should emerge as the next great growth story over the next several years, as the global economy adapts to address both climate change and the limited resources available to meet the demand of an emerging middle class in developing countries. ■

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