05 August 2009

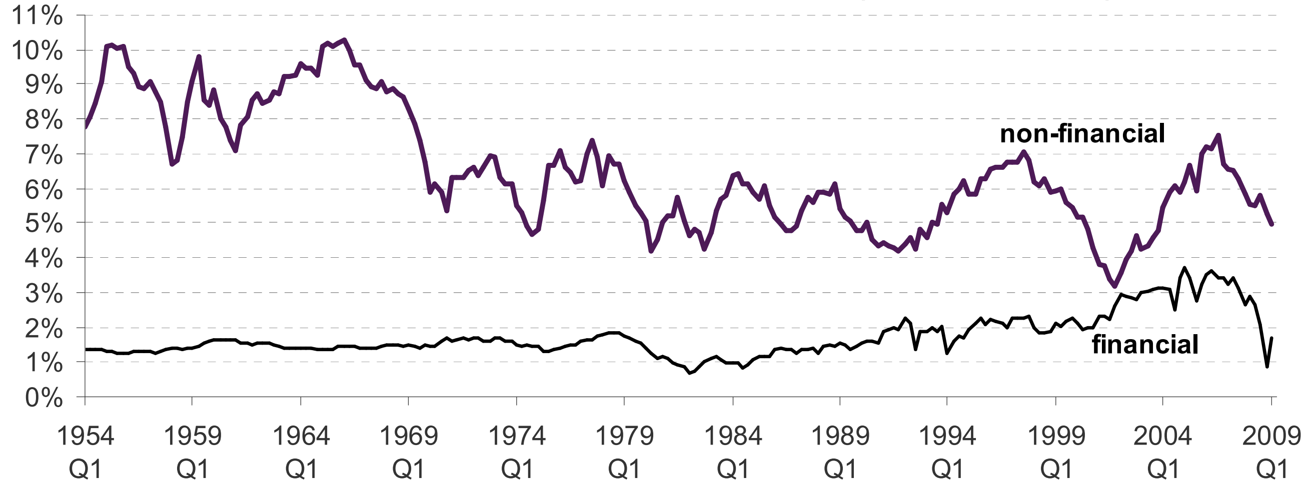
Asset price bounce: stocks √, commodities X

WE SUGGEST: Stocks to sustain current prices, hard commodities to fall

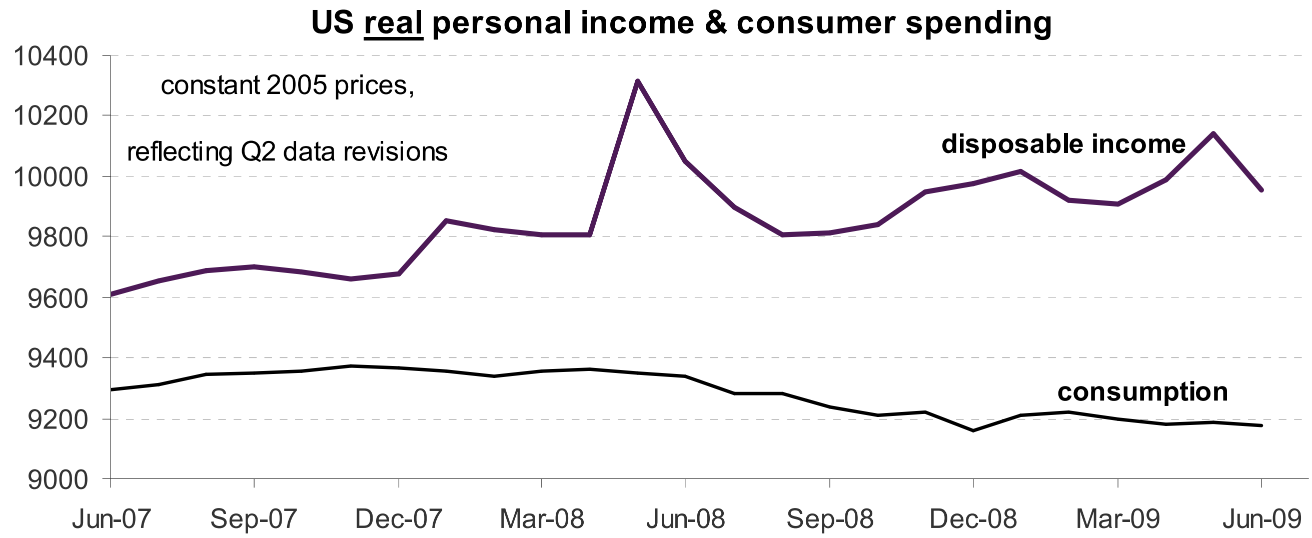
SUMMARY: The stock rally reflects a rebound from the excessive scale of winter falls, plus recovery prospects, the Fed's QE, and well sustained profits. But the latter involves falling wage and salaries. Real consumer incomes are further hit by surging gasoline. Chinese demand, much of it temporary for inventory, still leaves excess supply in oil and metals, whose current prices could soon threaten US recovery and the stock market.

The stock market rally is showing signs of maturity, with the S&P up 50% from its lows at just over 1000, but it is in commodities that the synchronised risk-asset bounce has clearly overshot – threatening even the (otherwise justified) stock price revival in the process.

US domestic corporate profits, % of GDP (pre-Q2 revision)



The bullish points about stocks include not only prospective recovery (mostly in the form of lesser inventory liquidation) with risk assets rendered attractive by the Fed's quantitative easing, but also well sustained corporate profits, at least in the US. The above-expectations Q2 S&P earnings data are no surprise to us, as the ratio of domestic non-financial corporate profits to GDP, despite severe recession, had only dropped in Q1 (Q2 not yet available) to around its 30-year average – well above previous recessionary lows. From what little we can deduce from the incomplete Q2 data, with heavy backward revisions so far only published for a few years, the ratio may be revised down somewhat, but the point remains that in the most severe recession at least since 1982, profits have held up quite well. As for financial profits, the Q1 bounce probably went on in Q2 as wide credit spreads in existing business are added to revived (old-style) investment banking revenues. This will probably get competed away – hopes of a full-scale financial sector bounce-back seem hopelessly optimistic – but over 2-3 years rather than 2-3 quarters. So we are sitting on a below-long-run-average p/e ratio off earnings reflecting the worst the recession can do: almost any recovery implies significantly better profits, at least in the non-financial sector. Europe and Japan may be less well placed, but their p/e's are also far lower.



The snag with strong corporate profits is the element of 'zero-sum game', as cost cutting that has sustained profits has also hit nominal incomes, especially wages and salaries. But what renders this especially dangerous is that real incomes are also being hit by the other big risk-asset bounce: in hard commodities. Real consumer spending only fell a minimal 0.1% in June, despite a 1.8% hit to real disposable incomes, but the flip side was a fall in the savings rate from its 6.2% May spike to 4.6%. Yet the relationship of the savings rate to net personal wealth indicates a need for it to rise to 8% or so soon, and the requirement for consumer deleverage points the same way. If real incomes are hammered by rising gasoline prices in future, as they have been recently, any increase in the savings rate could well ensure continued erosion of real consumer spending. In that case, any US recovery based on vulnerable factors like lesser inventory liquidation and rising state and local spending could be largely offset.

So the commodity play depends entirely on the China story being sufficient: not only in itself but also to outweigh the negative impact of higher oil and metal prices on US recovery. Yet even in good years like 2005-07, annual increases in Chinese oil demand were only 0.3-0.4 mbpd (about 5%) while the fall in US consumption has been three times this, 1 mbpd (also 5%) for each of the past two years. Turning to copper, electricity capacity installation is falling significantly from its peak two years ago. Chinese demand would be a weak plank on which to base soaring commodity prices even if the former boom were to resume. But who expects that? And who is not aware that recent Chinese import surges in oil and metals contain a large element of inventory build-up that must inevitably fade, if not reverse?

On fundamental value grounds, the S&P at 1000 looks well priced – where it should have fallen to had we avoided the down-up hysteria of the past 12 months. But commodities remain over-supplied relative to demand at these prices. If they go on up on speculative financial buying, their increase could not only prove self-defeating – they could drag the stock market down too by sapping a weak world recovery.

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