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Markets

Could stocks be headed for a new fall?

Some analysts are alarmed by surge in prices for both risky and safe assets, but most institutional investors just aren't listening

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Financial markets are off to the races and Wall Street has all but declared victory.

A surge in prices for both risky and safe assets is alarming some analysts who say emergency rescue measures that helped markets rebound may be setting them up for a new fall.

But most institutional investors just aren't listening.

Talk of a virtual circle of recovery in asset values and the real economy abounds at big banks, a sharp if cautious contrast to the dire pessimism that prevailed until recently.

Unusual simultaneous rallies in equities, U.S. government bonds and commodities are linked to one factor: Super-cheap monetary policies adopted around the world.

Bank stocks have led the runaway U.S. equity markets which that catapulted indexes nearly 60 per cent above March lows. This has meant better earnings, rising profits and bigger bonuses.

“We're in a sweet spot for the financial cycle,” said Jonathan Basile, economist at Credit Suisse in New York.

“Central banks are in no hurry to remove stimulus so that suggests risky assets could do better and fixed income could also do better.”

An analysis from Bespoke Investment Group captures the lightning speed of the rush into equities. Six months ago, the S&P 500 was trading further below its 200-day moving average than at any other time since the Great Depression.

“Today, we are in the midst of one of the strongest bull market rallies since the 1930s,” Bespoke said in a report. “This has helped to lift the S&P 500 further above its 200-day moving average than at any other time since 1983.”

Few disagree with Federal Reserve Chairman Ben Bernanke's contention that he had to flood markets with cash to prevent another Great Depression. But critics say his tactics pose risks of their own, making it harder for monetary authorities to gauge the exact level of stimulus their measures deliver.

One obvious candidate for an abrupt turnaround is the U.S. stock market. Not only has it recovered more than half its value in the past six months, but the rebound has also been largely predicated on a rally in shares in financial firms, many of which are still believed to rest on shaky ground.

An ongoing deterioration in consumer debt repayments and a worsening picture in commercial real estate are all putting additional strain on already-heavy balance sheets.

Joseph Stiglitz, a prominent economist and Nobel Laureate from Columbia University in New York, argued last week that the U.S. banking sector is now in worse shape than before the collapse of investment bank Lehman Brothers in September, 2008, because banks seen as too big to fail before the crisis had grown even larger.

Lehman's demise set off a cascading storm across markets that stifled lending, crippled global industrial production and exacerbated an already severe economic slump.

Much of the ground regained by equities since that period reflects understandable relief that both the U.S. Treasury and Fed rescues appear to have pulled the world back from the brink.

Coupled with explicit guarantees of an extended period of ultra-loose monetary policy from central banks, which emerged from the Fed's August gathering at Jackson Hole, Wyoming, this has underpinned much of the market's optimism.

Solid results from key banks have also assuaged concerns. Goldman Sachs Group Inc. (GS-N 183.40 1.94 1.07%) reported $3.4-billion (U.S.) in second-quarter net income, its best performance ever.

Yet bank profitability is expected to come under pressure from both increased credit losses and a tighter regulatory environment. JP Morgan estimates new rules alone will reduce long-term earnings potential by a quarter.

Beyond that, a grim housing outlook and high unemployment cast doubt on the viability of any consumer-led expansion.

“I'm not sure real estate is going to be a great investment ... and I still think the housing market still has a little bit further to decline, said Mark Calabria, director of financial regulation studies at the CATO Institute in Washington.

A Reuters poll shows economists expect a 14 per cent fall in home values for 2009 followed by a 2-per-cent rise next year.

The stock of vacant and existing homes has begun to come down but is still above 1.5 million units – not nearly enough, say economists at Deutsche Bank, to bring the excess supply of housing in line with historical trends.

The pace of job losses has abated but the unemployment rate continues to climb, and is soon expected to breach 10 per cent. That will be more than double its level before the recession started, the biggest jump since the Great Depression.

The average time people are left without a job has also grown and is now close to 6 months, the highest on record.

“The bleeding in the labor market continues to lessen,” said T.J. Marta, strategist and founder of Marta on the Markets. “Unfortunately, the structural overhang in various industries, like finance, housing and autos, is preventing the absorption of those who have already lost their jobs.”

It remains to be seen whether the unprecedented quantities of central bank funding can be removed before it has any unwanted side-effects. Already, a swooning dollar is making inflation-adjusted returns look less favourable.

Stock valuations are also increasingly less attractive.

Moreover, many believe Americans are undergoing a secular shift from spending freely to saving avidly.

A report from the Fed on Thursday offered more evidence of rising savings, showing household ownership of U.S. Treasury bonds rose to $605.9-billion in the second quarter from $576.4-billion in the prior period, a trend that suggests serious limitations to any investment strategy that relies on a quick bounce-back from battered U.S. consumers.

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