

What's with the stock market sell-off?

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Some market bears have been looking for a significant economic slowdown and are pinging off weaker than expected economic numbers (like the retail sales number). They also bemoan the trade deficit drag on growth and the falling dollar. For decades this group has been waiting for the trade deficit to trigger all kinds of global calamity. They argue that the Fed will have to aggressively raise rates to stop the tailspin in the dollar or dollar weakness will raise inflation. As a result, higher interest rates will trigger a collapse in housing and force the over-extended U.S. consumer to retrench. The global boom will then turn to global bust, as export led growth collapses.

We don't agree with the market bears. First, while economic numbers may be softening, they are hardly collapsing; even housing has remained surprisingly strong. Second, if the economy does soften as they expect, the Fed is not likely to aggressively raise interest rates. Third, the decline in the dollar is not necessarily inflationary. Foreigners have in the past responded to dollar weakness by cutting margins to keep prices stable and assure that they retain market share. Fourth, the consumer is not over-extended and has never been wealthier. Job growth is strong and personal income has been growing. If anything, we worry that too strong growth will keep the Fed in a reactive tightening mode.

Many analysts are worried about booming global economic conditions, rising commodity prices and their inflation

implications. Although this has been a recurring theme for over a year, we have yet to see a significant increase in core inflation, which continues to be locked between 1.5% and 2.5%. There has been a surprisingly weak pass-through of commodity costs to core prices because manufacturing productivity gains remain robust and global competitive pressures are keeping pricing power low. While rising commodity prices reflect strong global economic growth, they are only one small component of the corporate cost structure. Low cost global labor is easily offsetting rising commodity prices and providing a flood of cheap goods from overseas.

In addition, the commodity price spike we are seeing appears more speculative than fundamental. While robust global economic growth is putting a strong bid under commodity prices, the outsized gains have little to do with shortages. According to the ISM report of purchasing managers, of aluminum, aluminum products, brass, chemicals, copper, corrugated containers, crude oil, diesel fuel, electronic components, flour, freight, gasoline, nickel, paper, particle board, plastics, resins, silver, steel, titanium and zinc, only steel was in short supply. We believe prices are going up because of concern about potential supply disruption and speculative hoarding, not because there are shortages. The parabolic nature of recent price moves makes commodity prices vulnerable to serious corrections, particularly if global growth slows.

Likewise, high oil prices appear to be more speculative than fundamental. While supply concerns remain high due to headline news out of Nigeria, the Middle East and Venezuela, oil inventories remain high. A shortage of refining capacity does exist due to the long-term failure to add capacity, which leaves little slack in the system to accommodate seasonal maintenance or refinery closures due to catastrophes. However, refiners are coming back on stream and gasoline inventories are starting to build. Moreover, rising oil and gasoline prices if anything are deflationary, not inflationary. During April, U.S. consumers spent \$434 billion at gasoline retailers, a seasonally adjusted annual rate of about 4.5% of disposable personal income (only 0.6% higher than last year). On balance, gasoline and energy costs are not that big of a component of consumer spending. The psychological impact of higher gasoline prices is much greater than the actual effect of higher prices.

The bottom line is that the economy appears to be slowing like the Fed wants, global growth remains strong, and inflation outside of the energy complex is contained. As a result, we believe the market sell-off is more due to the fact that the strong rally left the global stock market overdue for a correction than any fundamental weakness. Global stocks remain attractively valued, earnings momentum is positive, and the long-term uptrend is still intact. Buy weakness!

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