

EQUITIES PERSPECTIVE

April 25, 2008
DJIA: 12,849

Grading on a curve . . . or ignoring bad news? If it's an ill wind that blows no good, thank you GE (33). The stunning revelation that GE "missed" speaks volumes to the financial crisis. If GE, the all-time master earnings manipulator couldn't pull it off, in this case sell some real estate, it does indeed seem a telling commentary. But they did at least seem to lower the bar for some rather dreadful earnings reports that followed – Bank America (38), Citigroup (26) and JP Morgan (47) to name a few. Our take, of course, is that it's always about the market. There's no bad news in good markets or, at least, none that can't be ignored or sliced and diced to suit the trend. The GE related selloff wasn't pretty, but it was at least brief. That's not too shabby when you think of GE as the bellwether of the U.S. economy, the second biggest stock, and all that. And the two week uptrend following that little mishap has been impressive, led in large part by the surge/shortage in the world of commodities.

It still seems likely there's a meaningful correction in commodity prices somewhere out there. The long term trend in commodities may be up, but short term many prices seem both extended and frothy. Ironically it all sort of goes back to the 1990s when oil prices were at record lows. Back then the Fed's unwillingness to take away the proverbial punch bowl created the tech bubble. Then, in 2003 to avoid the deflation scare, the Fed lowered its key borrowing rate to 1% and kept it there too long. By making money available at a negative real interest rate it encouraged mortgage providers to lend money to people who couldn't afford to buy a house in the first place. Of course now that the housing bubble has burst the Fed's aggressive rate cuts are fueling another bubble, this time in commodities. Normally bubbles don't end until something goes wrong, that being the Fed raises rates. Obviously that's not going to happen any time soon and a "flight to quality" has brought other Treasury yields down sharply. However, things may be changing in the Treasury market and at the very least, other free market rates are actually rising.

Like most things these days, however, any correction in commodities seems likely to be driven by China. Trying to cool the economy after nine straight quarters of more than 10% growth, China's central bank decided last week to raise the deposit reserve requirements of commercial banks to a record 16%, the third such move this year. It seems clear that if need be China is willing to bring about a recession to deal with multi-year highs in inflation. Since the beginning of 2007 growth in Chinese exports to the U.S. has been trimmed from 30% to almost zero. But probably the greatest evidence of China's slowing is the good old stock market. Chinese stocks have gone from first to worst – up almost 130% at their peak in 2007, and recently down 50%. Even Petrochina has been hammered, down more than 60%. While granted 2007 was bubble territory, 2008 has to be telling us something about that economy, and China's economy has been the growth engine for most of the world. If China accounted for roughly 80% of the world's incremental oil consumption in the past two years, a time the commodity has climbed from \$50 a barrel, it also has been the growth engine for much of the commodities boom.

Sufficient unto the day is the evil thereof, and there's no real correction in commodities as yet – maybe a little in Gold, certainly not in Oil. As a result, there's very much a segmented market. You can argue there's the Financials and everything else, but that doesn't tell the story of just how good the commodity stocks have been. It's certainly positive that the Financials seem to be holding, but there's been a real bull market in commodity stocks. Maybe Tuesday's IPO of Intrepid Potash (50) says it all. The fertilizer maker went public at \$32 a share, 14% above the mid-point of its proposed range, expanded its offering size to 30 million shares from 24 million, and then soared 58%. It may not be over, but that sounds a little frothy. Of course there's record demand for crop fertilizers amid the agricultural boom, but more immediate was last week's order for 1 million tons of potash from Canada for \$576 a ton – up 227% from last year. The buyer, surprise – China Sinofert. Our simple solution to any food shortage, and a chart as good as any fertilizer – Tupperware (40).

Any correction in commodities, except for the commodity stocks, wouldn't be bad. Indeed, a \$20 or \$30 pullback in Oil prices could well be the catalyst for another leg up. As it is, even at \$120 a barrel the market hasn't acted badly. We would always prefer weakness without the 2-to-1 negative breadth and expanding volume we saw Tuesday, but that almost seems the nature of markets these days. Back in the early 70's there were what we used to call "one decision stocks." Now there seem to be one-decision days but, fortunately, most are to the upside. Indeed, the 5-to-1 up and 3.5-to-1 up days of the 16th and 18th, respectively, seem pretty much trend defining. Despite a near collapse in Airline shares amid rising fuel costs, the DJ Transportation Average acts well. The Regional Bank Index and the Financial Index hold up and might even break out! And if you think Google (550) defied its critics with better than expected earnings, how about Ford (8)? Whether a low or the low, for now the trend remains up.

Frank D. Gretz

STOCK AVERAGE VS. AVERAGE STOCK

