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Alternative Investment Strategies

April Fools Month

It seems like a distant memory. Maybe the whole sub prime mortgage debacle was a bad dream and everything will be alright. It took the financial media less than a month to forget one of the worst quarters in stock market history. Actually, it took less than a day as the major market indices ripped on April 1 with the technology stocks leading the way up on the NASDAQ and the DJIA gaining almost 400 points. The indices ended the month with their strongest showing since September of last year. Earnings season got into full swing and as the write downs kept rolling in and oil setting new high after new high, the market took it in stride and said "it's not as bad as we thought so it must be good". While the current wave of investor optimism is a breath of fresh air after the overwhelming levels of fear in the first quarter, the complacency that has come along with that optimism will inevitably catch up with more than a few investors.

While equity markets surged during the month, commodities, with the exception of oil, cooled with traders taking profits from the prior quarter. A pullback in agriculture and precious metals was partially due to a strengthening dollar. After the US dollar index touched a historic low in March, the dollar set a new all time low against the Euro on April 22 of $1.6019 (per euro). Since that low the dollar has rallied close to 4% against the Euro and the broader dollar index is up over 3%. The dollar's short term rally can be attributed primarily to the Federal Reserve's more neutral stance on the Fed Funds rate. After cutting another 25 bps on April 30, the Fed has signaled that it is watching inflation closely. As a result, investors have tempered their expectations for further rate cuts. The fixed income markets have also priced in this pause as the two year treasury yield now sits above the Fed Funds rate of 2%.

Historically, the dollar and gold have shown a strong negative correlation. While both gold and the dollar are close to breakeven on the year, the path they have taken over the past four months reflects their historic negative correlation. After hitting $1,000 an ounce in March, gold has dropped over 10% while the dollar has rallied close to 5% off its low. From April 22nd, when the dollar set its low, through yesterday, gold has sold off over 5%. The next several weeks should be very interesting for traders as gold and the dollar look to break recent trading ranges.

The market is approaching a seasonally slow period ("Sell in May, go away" as the saying goes) and equity markets may be range bound until the next earnings calendar. That earnings season will likely be a repeat of this past quarter as firms continue to mark down illiquid assets and revise guidance down. In the interim, the market will look to monthly economic data for direction and may not look at the poor reading with such kindness moving forward. While the GDP reading showed the US is still not in recession, most Americans feel differently.

Recent polls show that voters are more concerned about the economy than any other issue, making it a priority for the presidential candidates. Politicians will continue to avoid the "R" word at all costs in hopes that the economic stimulus package and tax rebates will drive consumer spending, which represents about two thirds of the US economy. Nevertheless, consumers are tapped out and the continuing decline in real estate prices has Americans extremely concerned as the home equity ATM has officially closed down. More than ¾ of the $1 trillion dollars in outstanding mortgages are greater than 100% of the homes equity value. According to Harvard economist Martin Feldstein, more than 8 million homes are in negative equity. Allowing himself to be more candid than he was as Fed Chairman, Alan Greenspan recently said "the U.S. has slipped into an awfully pale recession and may continue to languish for the rest of the year. He also said it was too soon to declare and end to the credit crisis stemming from the collapse in the subprime mortgage market. Real estate prices are down over 15% off their peak and Goldman Sachs predicts another 10% decline in the US housing market. A 25% peak to trough decline would bring valuations roughly back in line with pre-bubble norms. Although we may not officially be in a recession the American consumer is already acting like it. We believe that recession started in December or January.

The impact of the economic stimulus package will have a tempered effect on consumer spending as higher oil and food prices will affect summer spending patterns. Rather than making discretionary purchases, consumers will likely pay off debt and use their rebates to pay for skyrocketing gas. As a result, several industries are likely to suffer including gaming and resorts, airlines, and the travel and leisure sectors. The entertainment industry may also be disappointed as fewer movie goers could limit box office receipts for the summer, which historically has been the industry's best season. Rather than taking the kids out for a movie at $10-$15 a person, it's more likely families settle down on the couch, microwave some popcorn and order a pay per view movie for $5. April saw the markets stabilize after a brutal quarter, but investors can ill-afford to be complacent. The risks facing the economy were brushed aside in April and the equity rally was a welcome breath of fresh air, but ultimately the next couple months will indicate if those April Bulls turn out to be April Fools.