ANOTHER MARKET CRASH?

What are the chances that the market will crash again as in 2008, when the US stock indexes fell anywhere between 45% and 55% from November 2007 – March 2009 and some foreign markets dropped even more?

DEFINITION

First, consider the word “crash.” Most people think of a crash as an isolated, sudden, unexpected drop of significant size, say 20% or more. But, except for the “mini-crash of 2010” that dropped 10% and lasted only a few hours before recovering to its previous high, we have never had a crash that was not preceded by weeks or months of market decline which then accelerated. Think of a car rolling downhill but rising up over some ramps along the way down. The farther down the hill – the greater the speed.

HOW BIG BEAR MARKETS BEGIN

In 2008, the 20%+ decline in October was preceded by a 20% decline that started in November 2007. The decline of 2000-2002 was similar. It had a fairly slow start, lasting from March to November in 2000, had a minor loss in 2001 and then picked up speed near the end. As in all really bad bear markets, the huge selloff that comes anywhere from nine months to three years after the start of the decline is the signal to get ready to buy because stocks are really, really on sale.

The crash in 1929 was somewhat different. There, only a few days preceded the 30% crash in October. However, that was a much different world, with only relatively few people really in the know, with rampant insider trading and stock manipulaton and other nefarious activity that would send people to jail today. Still, in 1929, in a few days the market recovered half of its loss before turning down again. Again, the biggest decline was at the end in 1932, three years later.

OVERVALUATION

The other thing the bad bear markets have in common was beginning at a point of extreme overvaluation in stocks. There are several measures of stock value but by far the most widely known is the price to earnings ratio, usually written P/E or simply PE.

The average PE on the previous 12 months of reported earnings has over the last hundred years been about 14. But in 1929 prior to the October crash, stocks had zoomed up to a PE of 32.6. The chart here at right shows historical PE peaks and valleys http://www.tradersnarrative.com/sp-500-price-earnings-ratio-long-term-chart-2330.html It does not show stock prices but each peak and valley roughly coincided with a change in direction for the stock market. On the peaks, one did not need to hit the exact top. The warning line seems to be a PE of 20 based on past earnings. A PE of 30 is extreme, hit just twice in the last 100 years. In 1999 it was 40. The best time to buy is when the market PE is below 10.

WHEN TO SELL

The market can have its best year after passing a 20 PE. So, when to sell? How early a person starts selling stocks depends on their risk tolerance. Setting a stop-loss order for most clients at a decline of 15% from the top keeps them in until the market rolls over but is not so tight that things are sold at the end of minor corrections of say 10%, whereupon the market quickly resumes its upward course with the person sitting in cash.

Right now we are at a PE of 14+, about average. We could still have a bear market (20% loss) but a really bad bear market like 1929, 1937, 1966, 2000 and 2008 with 50%+ losses? – probably not, because 2011 was a poor, not zoom year and the market is not overvalued. We may see a decline of 10% - 20% sometime this year, depending on world events, both political and financial.

ISRAEL VS IRAN

The biggest worldwide threats to the stock market are Iran, China and Europe (ICE). **Iran** is a bad news item I think will play out this year. Their nuclear program is dangerously close to the line for Israel. I would think Pres. Obama is still trying to get Israel to wait until after the US election but that gets into a time of difficult weather and basically means putting things off for a year. I don't think Israel will wait.

The map below gives the three most likely attack routes. One problem is that the Iranian sites are 900-1,000 miles from Israel and planes would need to be refueled during the flight, especially with the heavy bunker-busting bombs they would be carrying, so heavy that one plane can only carry one bomb.

http://www.bbc.co.uk/news/world-middle-east-17128991

For an excellent analysis on Israel attacking Iran see the BBC article http://www.bbc.co.uk/news/world-middle-east-17115643 . President Obama seems set on trying to get Israel to wait to attack, especially since he is up for reelection in eight months. He also knows only 19% of Israelis favor an attack by Israel without US help, though with US help the number in favor of attacking Iran jumps to 61%. Still, the Israeli government seldom pays much attention to polls, unlike the US and you can bet that the Mossad, Israel's brilliant intelligence department has far better information and insight than the CIA.

Bottom line – if the Nov. election gets here without an Israeli attack I will be very surprised. One should bet that there will be an attack by August at the latest and that oil, gold and US treasuries will spike.

CHINA

China is another worry. With the slowdown in Europe, which is now in recession, China's export growth last month was down to zero. Europe is their largest export destination and recession is just beginning there. Chinese officials just this week cut the economic growth target by about 25% down to 7.5%. China cannot really cut interest rates because inflation is running 4% - 5% already.

EUROPE

In Europe, S&P just downgraded **GREECE** to "default." This is after the bailout package was agreed to by the major parties last week. The main reason is that some parties were forced to take an "offer he can't refuse." S&P also disbelieves Greek claims that they will enforce austerity and of course Greece's economy is shrinking rapidly, not growing. Their debt to GDP ratio will thus be going up, not down.

The percentage of private creditors agreeing to that offer will be known Thursday. The deadline is 8:00 PM London time (GMT). I think Greece will give an extension to strong-arm the remaining creditors to take the deal, though some creditors think their chances are better in court and some have set themselves up to sue in the UK which they view as a favorable venue. They need 90% participation to avoid technical default, 75% to enforce recently inserted provisions to force the rest to accept the deal. That would very likely qualify as a "credit event" and put Greece in default. Participation of less than 75% kills the whole deal.

The picture is better in **ITALY** and **SPAIN.** Interest rates on government bonds have recently dropped dramatically there. Still, their economies are in recession and their austerity packages have not yet been fully implemented and further cuts and tax increases may still be requested by Europe's bankers – the Germans, French and a few lesser countries. In fact, Spain has openly defied the powers that be in Europe, saying it will not abide totally by the austerity measures ordered because unemployment is already 22% and more austerity would makes things worse. Greece is a perfect example.

UNITED STATES

With China and Europe slowing the US cannot help but be slowed as well, especially exports which are largely manufacturing and agriculture. Manufacturing has been the brightest part of the US recovery.

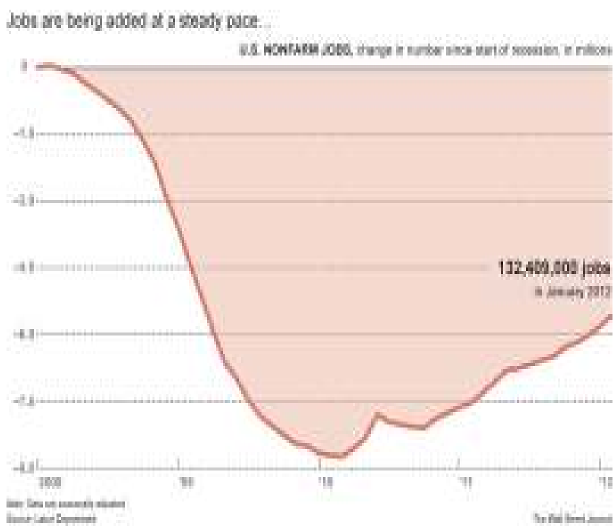
Consider too that most of the growth in GDP lately is due to inventory building. The actual growth in real final sales was only 1% last quarter. The US is not growing quite as much as people think.

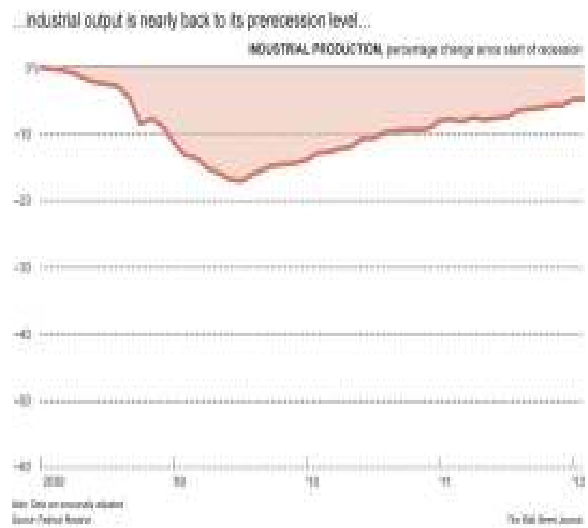
If prices on oil keep rising, that will also act as a brake on the US economy. $4 gasoline is already here in some states and close in most others. I expect to see $5/gal this year, based on my prediction for Israel to attack Iran this year.

WHAT'S POSITIVE?

ECONOMY – On the brighter side, the US economy is growing, albeit at a slow pace. Housing has picked up, though due in large part to a very warm winter that had construction building in January, even up north. Manufacturing has generally picked up, the poor report last week, notwithstanding. And, while I have explained in the January newsletter some of why the drop in the unemployment rate is considerably overstated, layoffs have slowed down and companies are hiring, though slowly in most industries.

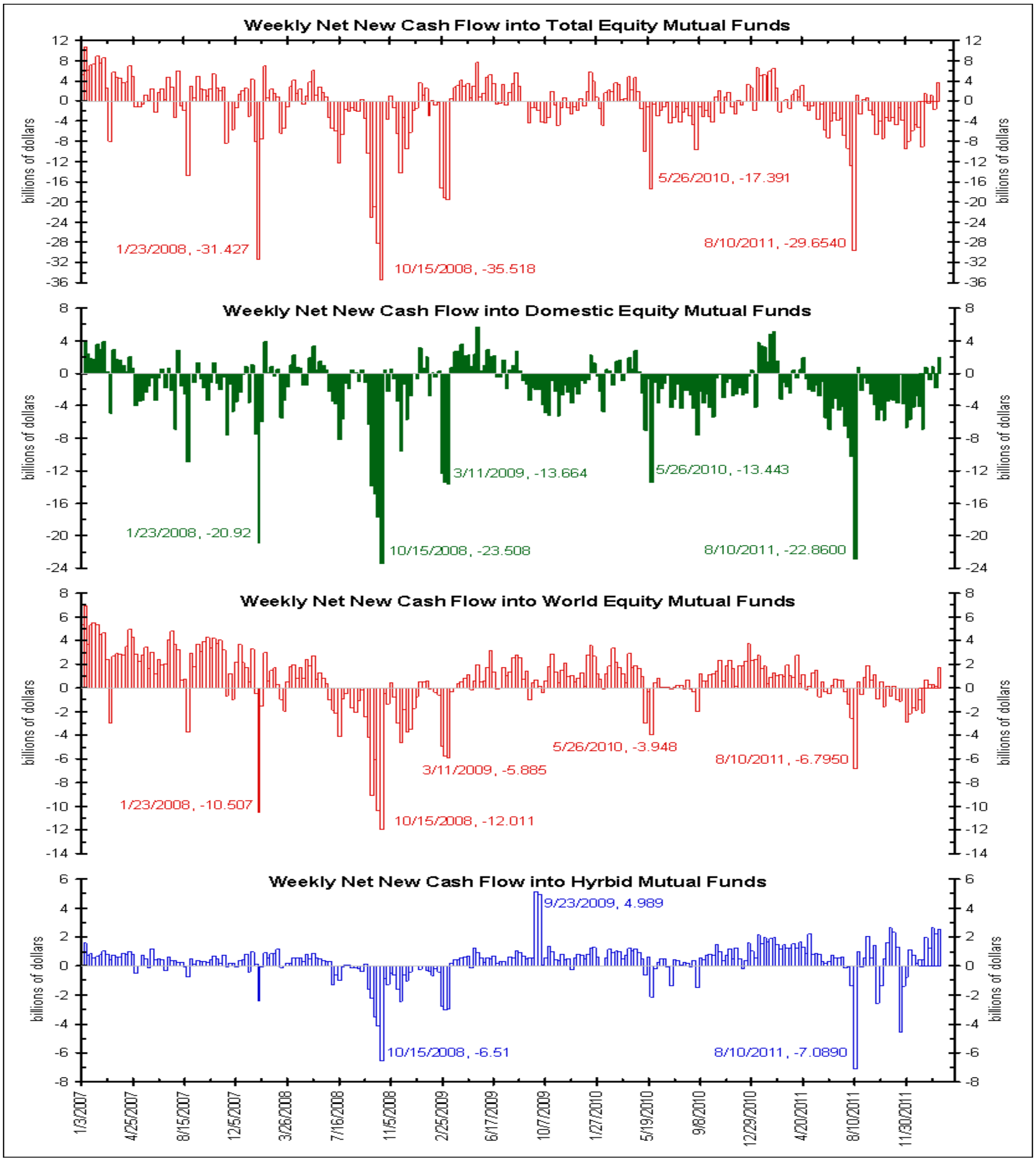
Look at these charts of US economy and you can see where we are now (Source: WSJ 3/3/12 Pg. A2)





STOCKS – A study looking at other periods when the US stock market went nearly straight up in the first two months of the year found that in every case it was higher still 3, 6 and 12 months later. This time could be the lone exception but who knows? Also, this is a presidential election year and rarely is there a significant decline in the market in a presidential election year. In fact, the only cases are in war-time.

A ton of investors with their money in cash which would provide fuel if the market keeps going up. As you can see below, investors are only barely starting to put money into mutual funds investing in stocks. There is a lot of money in money market and bond funds.



SUMMARY

I am cautious because of the risks I have described. But, I plan to keep stock allocations at close to normal levels until I see “irrational exuberance,” war with Iran, an economic slowdown in the US or a decline approaching the 15% level. My stock funds have been conservative with high dividends paying. That space has lagged in 2012 so far but will fare much better in any market setback. Please let me know if you have any thoughts on that.

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