

A Bull Market Requires a Healthy Consumer Underneath

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By Michael Pento

A year ago this week the stock market hit its nefarious 666 level on the S&P 500. Since that historic day, we have enjoyed a 68% appreciation in equities from their depressionary low. Not only has the bounce caused a chorus of perma-bulls to claim the worst of the recession is behind us, but also to declare that the bull market is here to stay.

But the cacophonies from those pundits who are now categorizing the move off the lows as a long lasting trend are overlooking an important point; a viable and sustainable bull market can only exist if the underlying economy and especially the consumer also enjoys the same healthy condition.

One of the hallmarks of a vibrant economy is that it is boosted by a consumer who has access to credit, expanding employment opportunities and real (adjusted for inflation) income growth. None of those conditions currently exists.

Last week the Bureau of Economic Analysis (BEA) announced that Personal Income decreased 1.7% for all of 2009, whereas Real Disposable Income increased by a paltry .9%. The only way the BEA was able to come up with only a slightly positive read on real income for the entire year was to claim that Personal Current Taxes decreased by 23.1% and inflation posted just a .2% increase in 2009! That's correct; even though other inflation gauges like the CPI increased 2.6% last year, the BEA claimed inflation was just flat. But even if you assent to their corrupted read on inflation, the point is still abundantly clear that income growth for consumers was absent. What's more, the lack of income growth is continuing in 2010. The BEA announced a drop of .6% in Real Disposable Income for the month of January.

In addition, last Friday the Bureau of Labor Statistics (BLS) announced that the U.S. economy shed another 36k jobs in the month of February. That number added to the 8.4 million jobs lost since the recession began in December of 2007. Therefore; even with the help of 15k census workers being hired and 30 months after the Fed began reducing interest rates and 17 months after Congress passed the Emergency Economic

Stabilization Act of 2008 which gave Treasury TARP authorization, the economy is still unable to produce any job growth.

But perhaps the most damaging blow to consumer's ability to spend is their access to credit. Let me point out that the need for consumers to deleverage has never been more acute and is exactly what is needed for long term growth. However, the short term effect of their reduced outlays will put downward pressure on GDP growth. That point being made, Total Loans and Leases at commercial banks were down 8.3% in the week ended February 17th from the same period a year ago. Consumers do not have access to credit primarily because there is no inflated asset class in which they can tap. Also, their level of debt has reached 95% of GDP, after rising from just 50% of output back in 1985.

Both businesses and consumers will suffer from a myriad of challenges in 2011. In the second half of 2010, the economy and markets will begin to discount rising interest rates-that will come either directly from the Federal Reserve or even more likely from the long end of the Treasury curve, which faces challenges from increasing inflation and supply. They also must contend with higher tax rates on dividends and capital gains, which are set to increase at the end of this year as well as an increase in the top marginal rate of nearly 20%.

Finally, the market bounce off the March 2009 lows and subsequent rebound in GDP has coincided with stabilization in home sales and prices. It was the real estate market that brought the economy to its knees in 2008 and also has been primarily responsible for its nascent recovery. However, government intervention in the real estate market (tax credits, takeover of GSEs, Fed purchases of Mortgage Backed Securities...etc) has created and pulled forward a tremendous amount of false demand. Now, even before the termination of government's meddling in markets, we already are witnessing a decline in home sales.

According to the National Association of Realtors, Existing-home sales - including single-family, townhomes, condominiums and co-ops dropped 7.2 percent to a seasonally adjusted annual rate of 5.05 million units in January, while purchases of new single-family homes dropped 11.2 percent in January from December to a seasonally adjusted annual rate of 309,000, according to the Commerce Department. The drop in new home sales was the biggest decline in nearly fifty years.

Renewed weakness in the housing market will only become exacerbated by the retreat of government- led artificial stimulus. And increased interest rates, taxes and regulations will place additional pressure on the consumer who is already suffering from a lack of income growth, access to credit and a high cost of living.

Corporate

profits have been on a tear and GDP grew at a 5.9% annual rate in Q4 2009. Those two data points have abetted the view that the economy and market are on sound footing. But the fact remains it took decades to accrue the mountain of debt that the consumer and government now stand upon. That fact, along with the Fed's decades-long manipulation of money supply and interest rates has caused the economy to become more addicted to inflation and debt than ever before.

Now we are

told by the same geniuses who missed the entire credit crisis that all our problems have been solved. Their faith is based on the fact that we have followed the same paradigm that created this debacle in the first place. If a country can tax, print and spend its way into prosperity, then going long the market here makes sense. If, however, you think; low taxes, low interest rates, a stable dollar, and low debt to GDP levels makes for a strong consumer and a sound economy, then this may be a better opportunity to at least sell some covered calls. Investors should start by selling calls on some of their bank shares like Bank of America (BAC) Wells Fargo (WFC) and Citigroup (C) that have soared since the lows reached a year ago.