An interesting analysis, from a bright friend. We agree, except for commodity prices. Enjoy!

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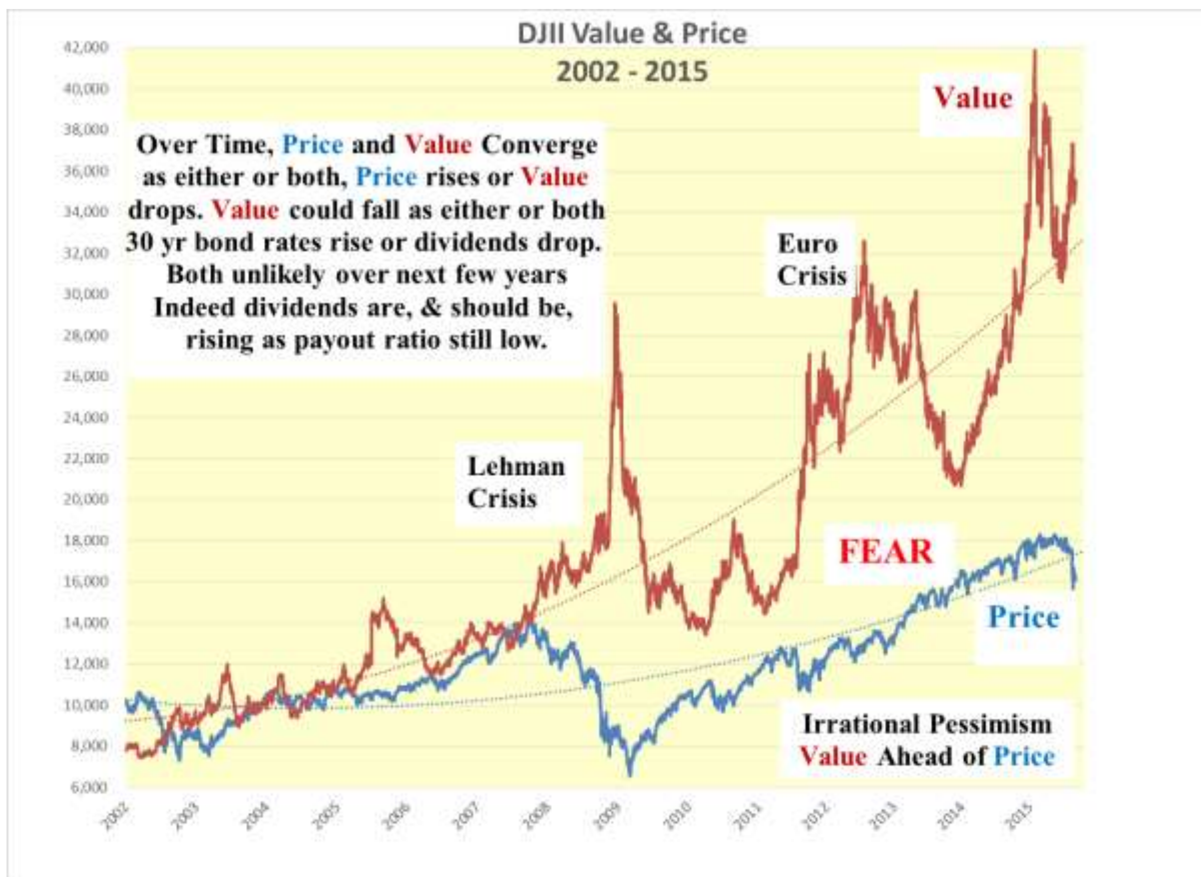
"Sell in May and go away, buy again after Michaelmas Day"!

(Old stock market adage based on the 18th century agrarian economy of England when money was required for seed in the spring and was available again following the harvest.)

While the extent of the latest correction is not justified by the fundamentals, this summer's swoon is vastly overdone. However, it presents a fantastic buying opportunity ahead of the long-overdue upsurge of the DJII price toward equilibrium with its dividend discount value of 35,539.



"Never before in the history of financial markets has so much been so agonizingly anticipated for so long by so many for so small an increase in the Fed funds rate!"

(With apologies to Winston Churchill, Aug 20, 1940)

The obsession of the media and many market participants over whether or not the Fed will raise the funds rate by a quarter of a point either this month, next month or next year is mind-numbingly stupid which along with all the accompanying sound and fury signify absolutely nothing untoward for U.S. equity markets.

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Over time the stock market is mainly driven by two fundamentals. Changes in dividends and long-term interest rates. A quarter of a point increase in the Fed funds rate will not change corporate investment decisions that span the next ten or even five years. And should have little or no impact on the 30 year T Bond Rate.

Furthermore, the Fed has stated repeatedly that any decision to change is data dependant. Raising the rate implies that economic activity is improving, which in turn should result in rising corporate earnings with the potential for further increases in DJII dividend from its already record level.

On Friday September 4, 2015 the DJII dividend stood at $429.88 and yielded 2.67% which was 93% of the 30 year T Bond yield of 2.88%. The dividend discount value of the DJII was 35,539 compared to its price of 16,103. The difference between value and price, 19,436 is the amount by which the DJII is underpriced.

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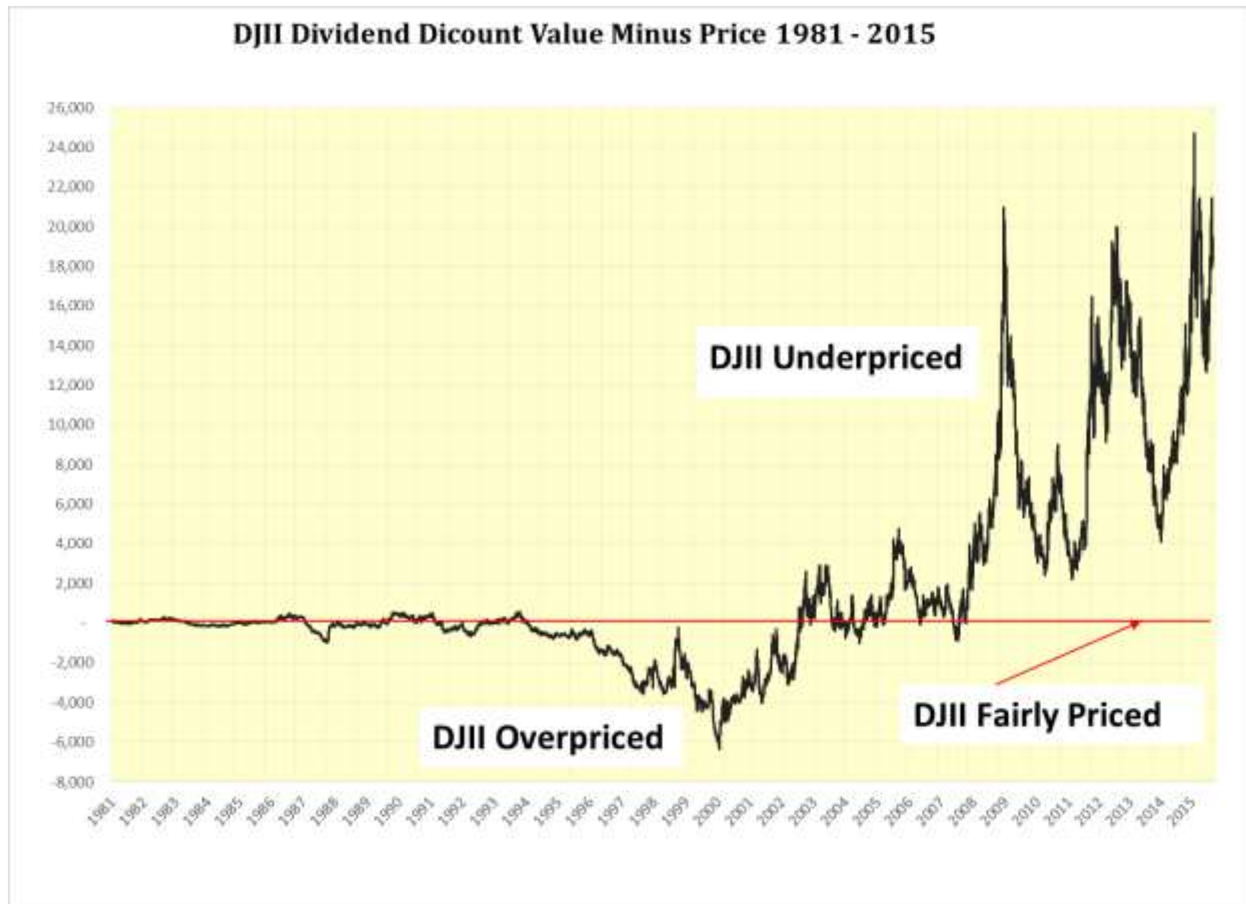
The next chart shows how cheap the DJII is compared to the years before 2008.



While not impossible, the probability of a U.S. recession in the foreseeable future appears very low. This should mean that the dividend of the DJII will at worst not be cut. Indeed it should continue to rise to new records. Hence, from this side of the dividend discount equation there should be no downward pressure on the value of the DJII.

The yield of the 30 year T Bond is the other part of the equation. When it rises it puts downward pressure on the value of the DJII and upward pressure when it falls.

For the value of the DJII to be in equilibrium with its price today, the yield on the 30 year T Bond would have to be 6.36%. This would put the dividend yield of the DJII back to its historical average of 42% of the 30 year T Bond yield compared to the present 93%.

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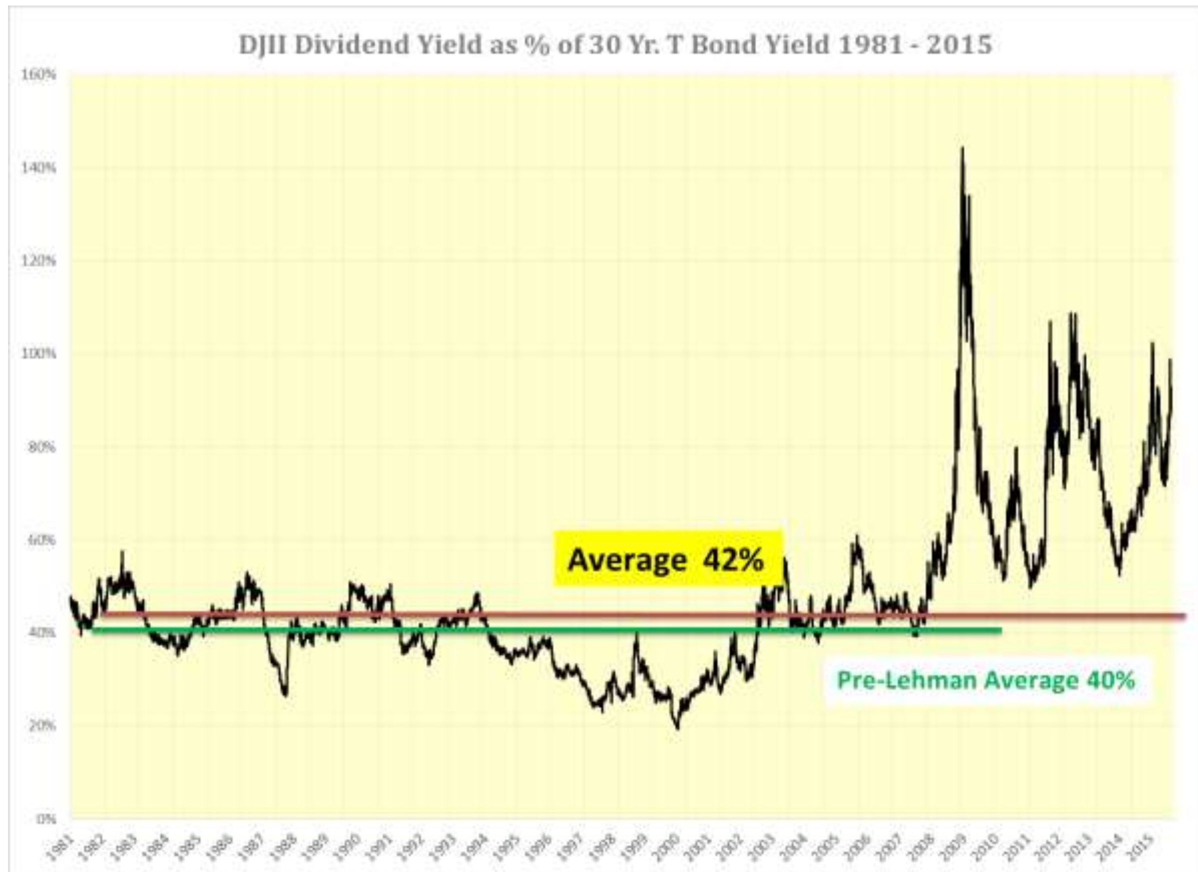

To reach a 30 year T Bond rate of 6.36% the Fed would have to raise dramatically the funds rate to create a flat or even inverted yield curve and such action would only be warranted if the economy were overheating and inflation rising. Under such conditions, however, both earnings and dividends would also be rising and offsetting part or all of the negative effect of a rising T Bond yield.

The search for yield among investors seems to be concentrated on current yield with little or no attention being paid to the actual and potential growth in yield that has been historically the attraction of equities. Furthermore, little or no heed is being paid to the near-term capital risk of bonds should the 30 year T Bond yield rise to 6.36%.

U.S. banks still sitting on huge excess reserves

Since 2008 the total U.S. monetary base has risen by $3.2 trillion from $0.8 trillion to $4 trillion. However, only 20% of the increase has made its way into the economy at large as $2.5 trillion is still sitting on deposit at the Fed as excess reserves. The amount of the monetary base at work in the economy is only $1.5 trillion. The much more modest increase in the actual working monetary base does much to explain the tepid nature of the economic recovery since 2009.

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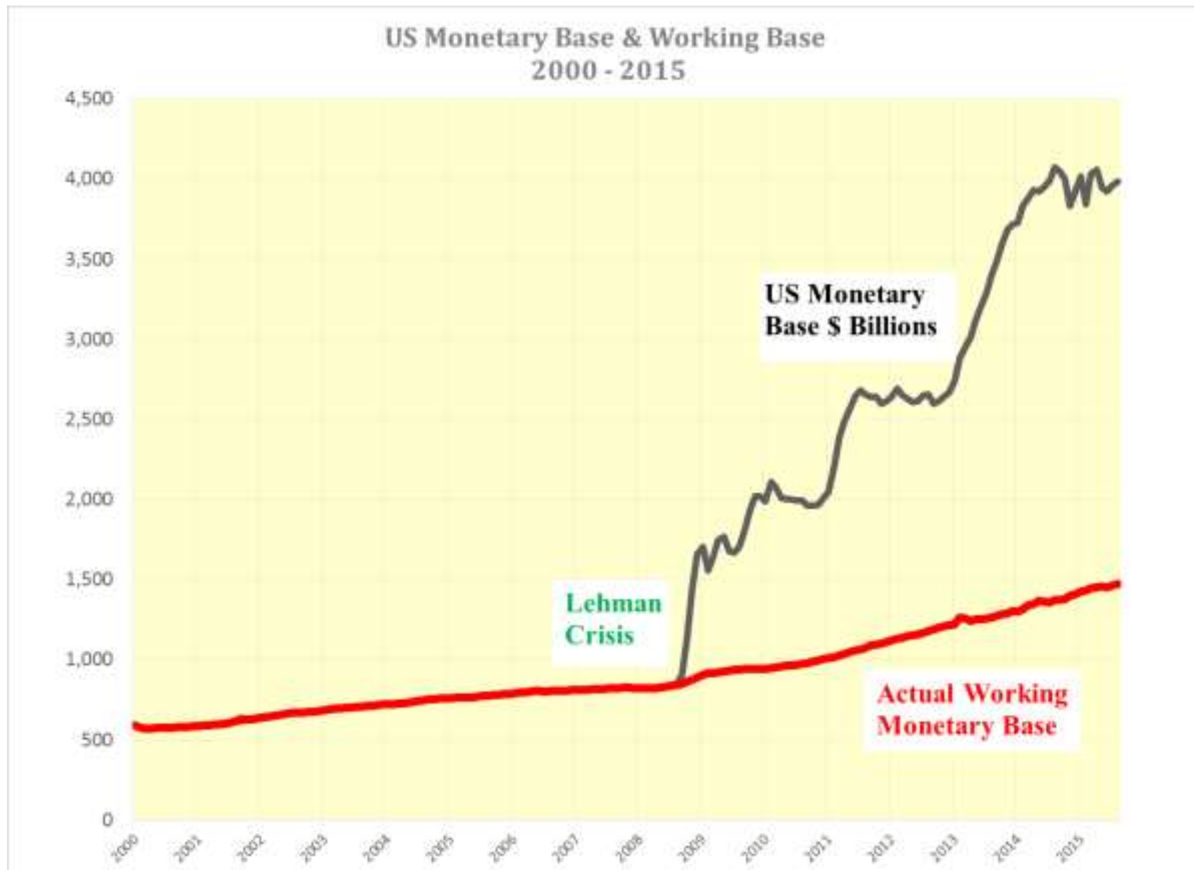

While the Fed may raise the funds rate it is hard to see there being any contraction of the total monetary base let alone the actual working monetary base. Should the Fed raise the funds rate and not increase the quarter point deposit rate on excess reserves this may encourage the commercial banks to move out along the yield curve and do what they are supposed to do, lend money to the real economy and not back to the Fed.

Couple such movement out along the yield curve along with existing and expected demand from both domestic and international investors with what looks like a pending shortage of supply of new US treasuries, it might even be possible to see a decline in the 30 year T bond yield. Such a development would push the DJII value even higher putting further upward pressure on the DJII.

U.S. dollar strength (?) due to QE of other nations.

The U.S. dollar is affected by the total monetary base relative to the monetary bases of other countries. Since the end of U.S. quantitative easing about a year ago almost every country in the world has been engaged in their own respective monetary easing policies. Thus, the simple law of supply and demand alone could explain the relative strength of the U.S. dollar and thus the attraction of U.S. sovereign debt with its higher interest rates.

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Oil price still expected to fall under $20 per barrel

As anticipated the price of oil has fallen. While there has been a rally of late is doubtful that this will last. U.S. and other production continues to rise and storage facilities are almost at capacity. With Mr. Obama's nuclear deal looking veto proof more oil should soon start to flow from Iran.

Production in Iraq continues to recover while Saudi Arabia and Russia maintain their open-spigot policies. ISIL will continue to pump and dump oil on the black market to raise cash for its nefarious activities.

Just as high prices are their own best cure so too are low prices and eventually the oil price should recover. However, just as the price of oil overshot on the upside and production expanded, it took years of investment, technological change, conservation and substitution to bring about the current oversupply, it could well take as many years to reverse this by halting planned expansions. Existing oil wells should continue to operate as long as cash flow is sufficient to cover lifting costs and interest payments.

As this year progresses the price of oil could well tumble to a market clearing price below US $20 per barrel. Not good for the oil producers but great for consumers.

One clear message is that this is much more a supply driven surplus rather than a collapse in demand. Hence, care must be taken not to interpret the oil price drop as a portent of an economic slump. This would be truly a case of the tail wagging the dog.

Lower oil price means lower production costs all round even for oil producers.

A lower oil price will have a positive impact on the costs of manufacturing, transportation, mining, logging etc. which will see a further positive impact from the lower Canadian dollar. Lower costs increase profit margins, profits and dividends that should all feed through to increased share prices.

Modest U.S. dollar gold price recovery still expected.

Over the past year the U.S. dollar price of gold has fallen by 11% but in many other currencies the price has risen as those currencies have weakened. This probably stems from a combination of the ending of QE in the United States and the imposition of easy money policies in other countries as well as lower oil and commodity prices in places such as Australia, Brazil, Canada, Mexico and Russia. Once again the supply-demand argument is at work in the currency markets.

The U.S. price of gold should rise as world economic activity rises sufficiently to slow and eventually stop the printing of money and gold production adjusts to the reality of the very high production costs. Even if it is only the result of no new mines being started.

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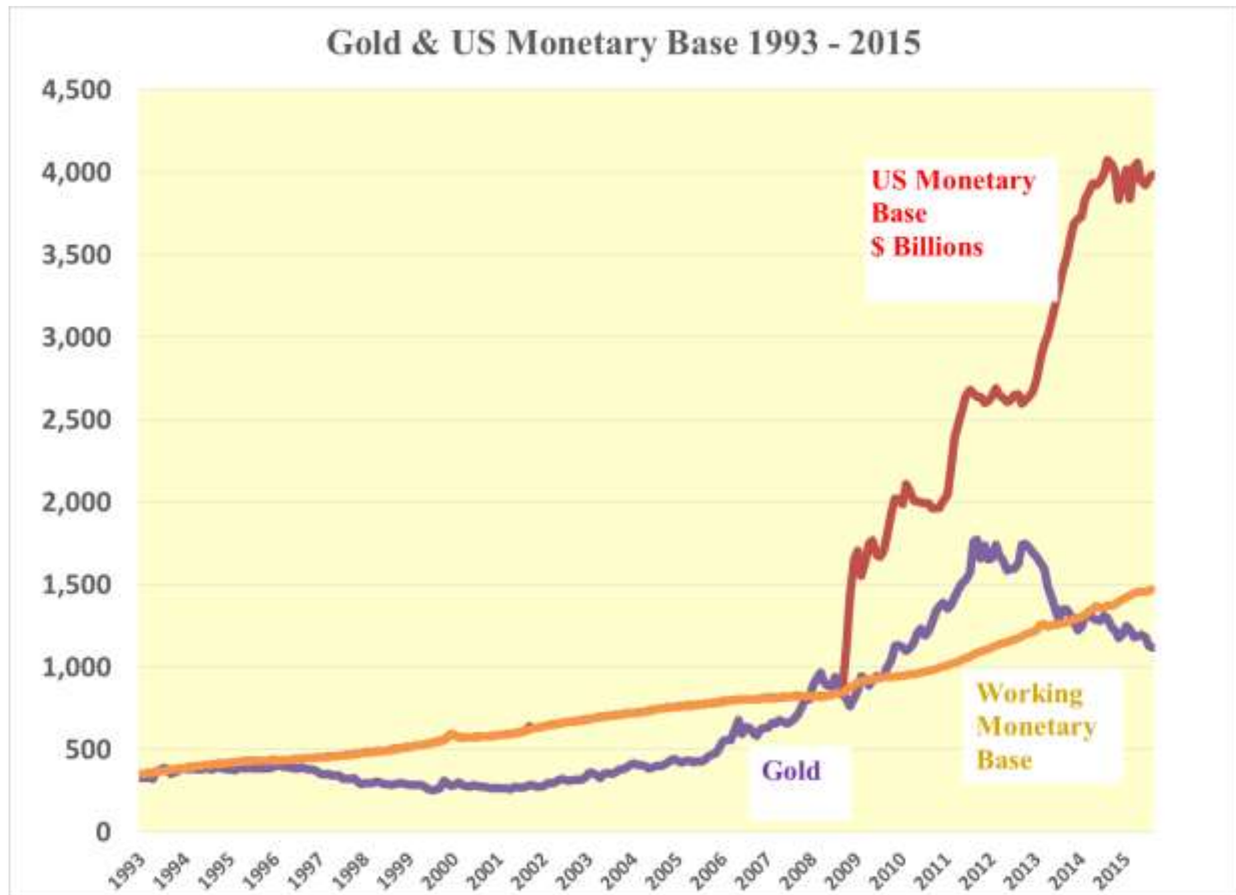
While no fireworks are expected, the price of gold should move above US$1,400 per ounce which would be more in keeping with the actual working monetary base which unlike the total monetary base is still rising and should continue to do so as argued above.



Data Sources: US Federal Reserve, Dow Jones, Bloomberg and the London Bullion Market

Base Metals

Time to start looking at my first love again particularly Copper, Nickel and Zinc as economic activity continues to strengthen and LME inventories decline. More thoughts to come.

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