UPA Investments Pty Ltd

Investment Newsletter

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From the Editor....

Market Update

It is interesting to note the “there is so much cash out there” argument that is being made by many financial commentators at the moment. We don't believe in weight of money arguments as we believe they are short-term and low quality. However, it seems just about everyone else thinks they are a high quality argument and investment strategy should be based around basically front-running where cash will find a home.

The one thing we do know is for some reason in the next 2-3 months is that when global equity market sentiment turns sour, this mysterious “cash pile that underpins the market” will be nowhere to be seen. We are not basing any investment strategy around a view on cash levels.

It was interesting to see a recent article on the front page of the Australian Financial Review which had economists pushing the government to reduce the amount of stimulus in the Australian economy. Don’t we have short memories in this country?! It was only 5 short months ago that the same economists were suggesting the Rudd Government hadn't done enough to counteract the likely effects of the “deep recession” we were entering!

We believe that it would now be a mistake for Canberra to withdraw the fiscal stimulus. We don't believe the Australian economy is as robust as we all are lead to believe and we think the only reason we avoided recession was the excellent pre-emptive moves by the RBA and the Rudd Government in the initial stages. With the Aussie dollar heading higher our export earnings are going to be crimped, while banks remain selective in their lending, particularly to business.

The property market will surely falter as the end of the First Home Owners Grant is wound down and interest rates edge up, whilst the consumer wont get another $900 anytime soon. We are not out of the woods yet by any stretch of the imagination and we think it would be a strategic mistake to unwind broader fiscal stimulus at this stage. But the debate alone should see some heat come out of domestic cyclical stocks that have been propped up by monetary and fiscal policy stimulus. We really hope they haven't put 30 x Price Earnings figures on stocks on 49-year low interest rates and unprecedented fiscal stimulus, but we suspect they have.

Valuing the Market

The crowd is often right except at market turns. After the turn, the crowd tends to holds on until most previous gains vanish. In a secular bull market, such optimism works out acceptably well. In a secular bear market, rampant optimism is severely punished.

There has been plenty of debate over whether equities are overvalued or not, and certainly we would assume that most people know where we stand on the topic.

On an operating basis, the trailing Price Earnings (P/E) multiple on the S&P 500 in the US has expanded a massive 10 points from the March lows, to stand at 27.6x.

When all the write-downs are included, the trailing P/E on "reported" earnings just widened to its highest levels in recorded history of nearly 140x, which is three times the levels prevailing during the height of the tech bubble.

It is interesting to hear market bulls talk about how distorted it is to be using trailing multiples that include 'recession earnings' (even though using 'forward' earnings means relying on consensus forecasts on the future and these are rarely, if ever, correct).

It is also interesting that the last time the multiple was this high was back in March 2002, again after a huge countertrend rally that deployed 'recession earnings' from the 2001 downturn. This was right around the time that the bear market rally started to roll over and in fact, six months later, the S&P 500 was hitting new lows and 34% lower than it was when the multiple had expanded to ... today's level!

Bullish analysts like to dismiss the actual earnings because they are "depressed" and include too many writeoffs, which, of course, will never occur again.

The consensus is usually overly-optimistic, which is why so many analysts love to do their analysis on "forward" earnings since the market almost always looks "attractively priced" on that basis. The reality is that the forward P/E multiple is now at 16.2x after bottoming at 11.7x at the market lows.

The multiple has not been this high since February 2005 when the economic expansion was already nearly four-years old! Today's stock market, on this basis, is now being priced as if we are late in the cycle -- forget this mid-cycle valuation stuff.

At the October 2007 market highs, the forward P/E multiple was 15x compared to 16.2x today, so you can understand why it is that:

1. We think investors are paying too high a price to participate, and;

2. We think that valuations are closer to levels more befitting an economy in its more mature stages of expansion than in its infancy.

Valuation may not be the best timing device, but it still pays to know whether you are getting into the market at acceptable prices. If the S&P 500 was in a 700-750 range, pricing in zero to 1% GDP growth, we would certainly be interested in boosting our allocations towards equities. But at 1,070 and over 4% GDP growth effectively being discounted, we will be spectators as opposed to participants, understanding that the key to success is to NOT buy at the peaks. So the strategy is to sit on the sidelines, be selective in our equity choices, and wait for the correction to come or for the fundamentals to catch up with this overvalued, overbought, overextended market. Remember, the reason why the tortoise won the race was because the hare got tired.

What do we know from 60 years of historical data? We know that the market typically faces serious valuation constraints once it breaches the 25x P/E multiple threshold. The average total return a year out for the S&P 500 is -0.3% and the median is -6.2%. The total return is negative a year later 60% of the time, so when we say that there is too much growth and too much risk embedded in the equity market right now, we like to think that we have history on our side.

This rally has the same look and feel as the 1930 DOW rally. Is there more left? No one knows. What we do know is that on average it does not pay to play for it.

Oil Update

We are beginning to wonder if everyone is mistaking investment flow and currency asset allocation for economic recovery. Are markets putting a P/E on investment flow, the very same investment flow that could reverse dramatically if the US dollar rallied for some unexpected reason?

Crude oil continues to defy gravity versus the actual demand numbers that keep coming out globally in the oil space. We feel that crude oil and oil stocks are due for a quick sharp correction. WTI Crude oil has been a huge beneficiary of buying from commodity index fund buying from pension funds putting money to work in the space and when you look at the weighting of crude oil in the most followed commodity indexes like the Goldman Sachs Commodity Index (GSCI) that tens of billions of money tracks. Crude oil is 32% of the index below and therefore for every US$1 billion a pension fund puts into the benchmark, the fund manager has to buy US$380 million worth of crude. You can see with the huge inflows into commodity funds in recent times (out of USD's), clearly that is where a lot of the support for the crude oil price has been coming from lately.

None of the major global oil mining companies are saying that they are seeing any signs of demand returning to global oil markets from end customers. So if they are not seeing any true pick-up in demand, then who apart from these financial buyers is actually buying crude oil at these levels?

Even though a big US Pension Fund might say they are an investor, they are really a speculator when you think about it as they are only putting money into commodities as they think they are going up in value over time and we can't help but feel there will be a correction coming in crude oil markets.

In the past week or so we have seen the Saudi's who dominate global production (around 8 million barrels per day at the moment) cutting prices for all their grades of crude be it light, medium or heavy crude. Arab light crude for US buyers was reduced in price by US$1.70 per barrel to US$4.60 per barrel discount to WTI crude pricing. Last week the Iranian National Oil company followed suit and clearly these huge oil producers are not giving discounts due to strong demand. These discounts are not to do with the freight markets coming back in global shipping markets and are simply to do with weak demand.

Crude oil stockpiles in the US remain around 338 million barrels of oil and they aren't low by any means. They are in fact high into what is expected to be an unseasonably warm US winter that will see heating oil demand drop.

Some may ask—what about the Chinese buying oil assets everywhere and potentially spending $6 billion in Nigeria to gain exploration licences? Well we also saw 10 deals in iron ore in Australia a few months ago but that didn't stop iron ore prices falling –30% since then. The Chinese investment is a long term story and our view is for a quick $10 correction in crude.

WTI oil is the classic example of investment flow clouding the true supply/demand fundamentals which remain weak. While everyone points to China, it is worth remembering that China only accounts for 10% of world oil demand and to get oil moving you need an OECD demand recovery, not just investors buying baskets that oil is a heavy weighting in.

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Information in this Newsletter is drawn from various sources, including extensive and comprehensive research by Fat Prophets, FN Arena, Bloomberg and the local press.

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