

Signs of a Bull

20 January 2009

2009 is turning out to be a year where visibility is low and making a forecast is fraught with risk. An unprecedented deleveraging process by the private sector is followed by record breaking public intervention. The effectiveness of government measures and central bank policies is likely to drive equity returns this year. The current bear market started with the credit markets and spread across various asset classes. Any sustainable recovery in equities should first see an improvement in credit markets, stabilisation in commodity prices and easing deflationary expectations. Below, I present eight indicators that may signal if we get a bull or a bear in 2009.

Within the interbank market, LIBOR is seen as an indicator of counterparty risk. Set every morning in London, this rate is used as a reference for a wide variety of financial instruments. At the height of the credit crisis after Lehman Brothers collapsed, the 1-month US dollar LIBOR surged to 4.59% as distrust among banks grew. This occurred despite the FED lowering interest rates. As of writing, the same rate has fallen to 0.36%, close to the targeted Fed Fund Rate of 0-0.25%. LIBOR close to FED rates is a sign that measures to stabilise credit markets are working.

Commercial paper market, a form of short term funding, is another area investors should monitor. Another victim of the Lehman aftermath, the commercial paper market saw direct intervention by the FED to a tune of US\$334bn. Since then, non-financial 3-month commercial paper rates have fallen from 2.24% to 0.29%, in line with lower FED rates while issuance has started to increase.

Besides bank borrowing, companies can turn to the credit market for medium term funding needs. Corporate bond yields, an indication of lenders' willingness to extend credit, have fallen since mid-October from 9.54% to 7.91% for investment grade bonds. High yield bond prices, or what is also known as junk bond, have also recovered, gaining by 22% since its November lows. The willingness to take up corporate bonds, even high yield, is another sign of recovery in the credit markets.

If government and central banks measures are to work, we should be able to avoid the severe deflation that the bears have been trumpeting. The amount of money created through quantitative easing by the FED should produce inflation in the future if banks and credit markets can multiply the money. Here, investors can check the Treasury Inflation Protected Securities (TIPS) market for investors' expectations on inflation. The principal of these inflation linked bonds increases with inflation and decreases with deflation, as measured by the consumer price index. At the darkest hour of capitalism, the TIPS market was forecasting deflation for the next 6 years with price declines of around 11%. Since mid-November, the yield on TIPS has fallen, signaling falling deflationary expectations, which is bullish.

Beside being an indicator of inflation, commodities are also forward leading indicators of industrial activity. The Reuters CRB Index, having fallen by 56% since July last year has recovered 6% from its low in November. The S&P GSCI Industrial Metals index have also recovered some 7% of its recent lows. Stabilisation in the commodity prices is key to a sustainable recovery in economy and equity markets.

The Baltic Indices are a set of indicators especially important to Asian equity markets. A recovery in trade should be preceded by some form of improvement in shipping rates. The good news is that the Baltic Dry Index bottomed at 663 and was recently hovering around the 880 levels. The Baltic Capesize Index, which some observers say is a lead indicator of the Dry Index, has recovered some 112% since its December 2008 lows. As with commodity prices, a sustained recovery in shipping rates would be equity friendly.

Risk aversion, which directly impact equity returns, can also be seen from the currency markets. Watch the funding currencies like US dollar and Japanese yen. Their price action relative to high yielding currencies like the Australian or Canadian dollar can give an indication of investors' willingness to take risk.

Finally, look at the internals of the stock market for signs of strength. Cyclical or economic sensitive sectors should continue to outperform the broad market if we are to see a sustainable recovery. As of writing, consumer durables and small caps have outperformed the S&P 500 by 13.4% and 6.1% respectively since the November 2008 lows. Even semiconductors managed a 12.2% outperformance. However, financials are a lagged during the current rally.

With such low visibility in markets, I am reminded of the story of the blind men and the elephant. Feeling different parts of the elephant, each gave a different and wrong description of the animal. Reality is not what it seems till we piece together the big picture. Looking across various asset classes should give us a better idea if the sputtering equity rally out of the Oct/Nov lows is a bull or a bear market rally.

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