

The Square Root Recovery

Fidelity Viewpoints

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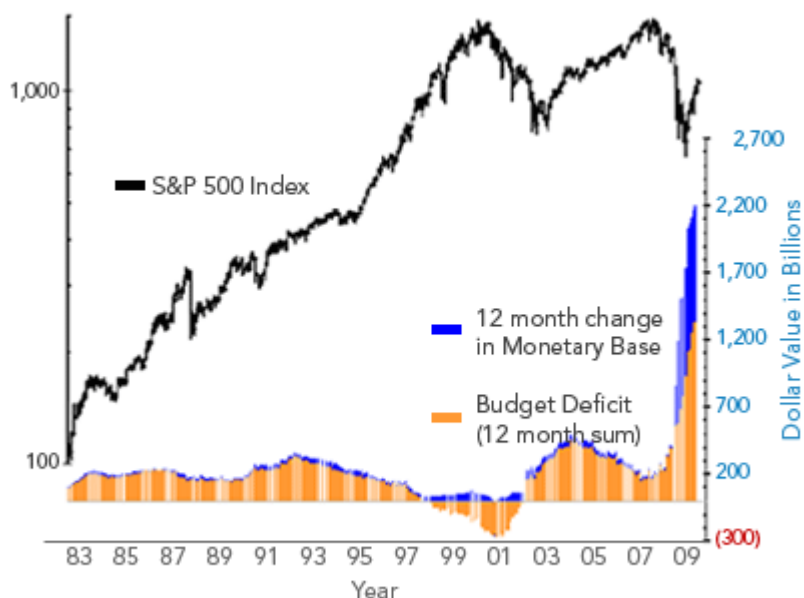
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Here we are six months after the end of one of the worst bear markets ever, and the S&P 500® has rallied 62% from the March lows through the September 23 high. This makes it one of the strongest and fastest rallies ever, prompting the inevitable question of what's next? Was it all a sucker's rally that is about to unravel, or are we in the middle of an as-yet incomplete bull market?

For me it comes down to two basic questions: One, now that the recession is ending, how strong will the recovery be and what comes after? Will it be a "V", a "W", a "U", or something else? Two, how much of the improving economic fundamentals are already reflected in the price of risk assets? Does the market fully subscribe to the recovery thesis? The way I am looking at things, there is good news on both fronts. Translating the above into a highly scientific mathematical equation, I get: strong "V" + skeptical investors = higher stock prices. In other words, a myriad of leading indicators suggests that the economic recovery is for real and is taking the shape of a classic V-shaped inventory cycle. At the same time, sentiment remains surprisingly (or perhaps not so surprisingly) skeptical. Put these two together and you get a "pain trade" (to use Wall Street jargon) that continues to point "up" for stocks.

Let's explore this equation a bit further. First the recovery thesis: A host of leading indicators suggests that a bona fide V-shaped inventory recovery is in progress. (This describes the visual created by charting a severe downturn in the economy followed by a strong upturn in economic activity.) The evidence is clear from manufacturing surveys, inventory data, credit spreads, low interest rates, the steep yield curve, stabilizing home prices, and finally the massive doses of monetary and fiscal stimulus which would show a V-like pattern. These indicators paint a compelling picture for the economy over the next year or so. But what comes after the "V"? The consensus certainly believes that it will be a "W," where the economy may dip down again in 2010 after the boost from inventory restocking has been realized. This is probably why so many investors have not gone back into stocks. They simply don't believe the recovery has any staying power.

Unprecedented Stimulus



Source: FMRCo, Haver Analytics monthly data as of 9/30/09.

The thinking goes that the American consumer has been "scared straight" into saving and has experienced a "moment of clarity" in terms of seeing the need to live within his or her means. As a result, the savings rate should continue to climb. It has already risen from 0% to 5% percent, but perhaps it will continue to rise to 10% or so. If that is the case, the economic headwinds stemming from a rising savings rate will continue for undercut growth. With consumer spending composing some two-thirds of GDP, if the consumer doesn't show up after the "V", then we could relapse into a "W."

But who says that this is the way it has to play out? It all comes down to what drives the savings rate. From my perspective, the savings rate is determined by household net worth relative to disposable income. While income is down as a result of rising unemployment, net worth is finally starting to improve again, after a \$14 trillion hit in 2007 and 2008. Household net worth is heavily influenced by home prices and stock prices, both of which are now recovering.

This suggests that the rise in the savings rate (from 0% to 5%) may well be ending. If the savings rate stabilizes here, then consumer spending could stabilize as well. This would be a big deal as it suggests that the "V" may not relapse into a "W" but instead will morph into more of a "square root" sign $\sqrt{\quad}$.

Of course, with credit tight and home equity values only a shadow of their former selves, a return to the boom years of the early 2000's (fueled by the liquification of home equity) seems extremely unlikely. But such a scenario wouldn't even be necessary for the market to sustain its rally, for it would be a better outcome than is currently priced into the market.

Where are the bulls?

If the "square root" thesis is correct, then all those investors who remain on the sidelines waiting for the relapse may be sorely disappointed and may find themselves chasing the market higher.

Currently, investor sentiment is nowhere near where it would normally be after a six-month 60% rally in stock prices. A variety of sentiment surveys shows only marginally more bulls than bears, and fund flows have been nothing to write home about. Meanwhile, hedge funds have lagged badly behind both the market and their long-only competitors. It is clear in talking to investors of all stripes that many of them remain highly skeptical. If anything, they will get in -- but only if the market corrects 10% first.

But is it ever that easy? Will the market really give in to what so many investors want? Not likely. This is where the pain trade comes in. The pain trade means that the market will do whatever causes the most pain to the most players. With the economic news flow positive and investor sentiment skeptical, the pain trade continues to be higher.

If at some point the "V" scenario starts to unravel or -- more likely -- investor sentiment finally catches up to the economy, then it will be time to turn more cautious on the market. But we're not there yet.

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