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THE X- FACTOR REPORT

Market Strategies, Economic Analysis, Risk Management

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DOW 20,000? Not Anytime Soon!

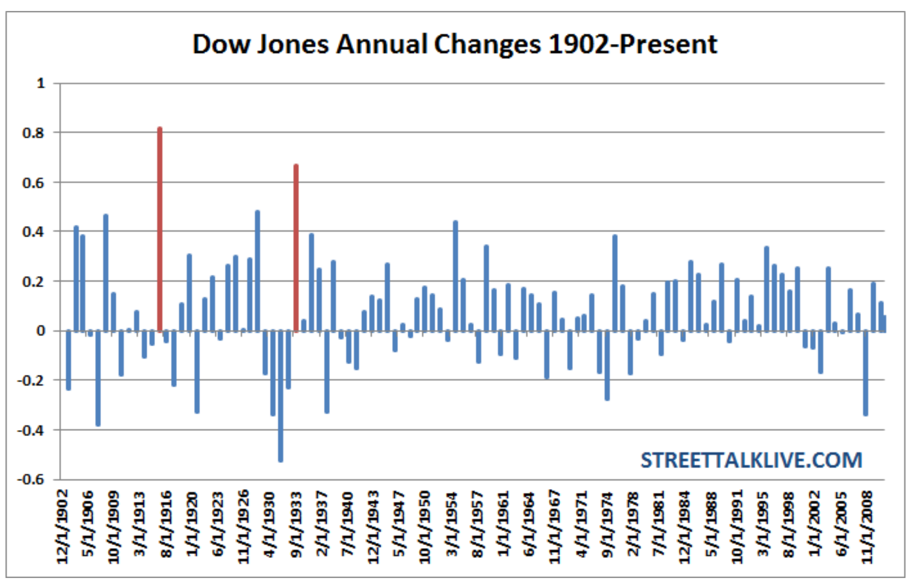
by Lance Roberts

This past week, as I watched our recent predictions about economic weakness and a market correction unfold in front of me, I ran across the James Altucher article entitled *"Next Stop: Dow 20,000 – 10 reasons why the market will soar."* I am always intrigued by the never ending optimism that abounds in most market journalists but James Altucher is no slouch so it really got my attention.

First, I do not have an axe to grind nor am I attacking anyone. I also happen to believe that the Dow will achieve 20,000 – but just not within the next 12-18 months as predicted by James as I quote: *"The market every now and then needs a day or two to rest. Maybe even more than a day or two. But over the next 12 to 18 months I expect to see Dow 20,000."*

It is a pretty ambitious statement and a nice big round number – 20,000. First, that would entail another 64% increase in the value of the Dow from current level (which isn't impossible; just highly improbable) and secondly, I had this same discussion about Harry Dent's prediction of Dow 36,000 back at the beginning of this century and we are still waiting on that one to happen.

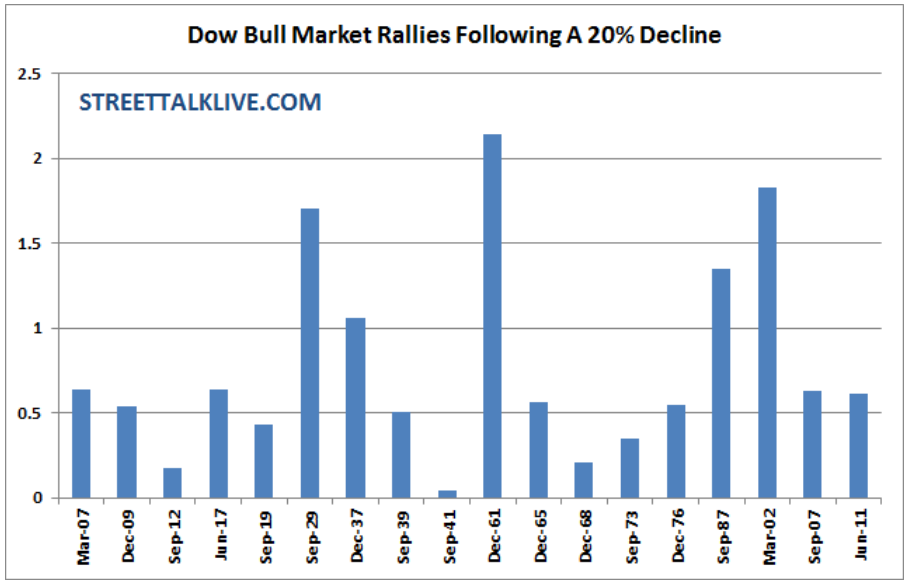
However, let's just look at the probabilities of another 64% rally from current levels. The first chart to the right is the Dow going back to 1900 and is the annual change in the Dow from Jan 1st of each year to Dec 31st.



As you can see over any given 12 month period there have only been 2 one year periods where the Dow managed to rally more than 64% - so, as an odds (risk) manager betting on a 1.8% chance of something happening doesn't seem like a great idea.

James did say that the Dow could reach 20,000 over the next 12 to 18 months. Let's just throw out the time table altogether and look at the odds of a 64% rally before there is another correction of 20% of more. Now our odds improve to about 23% - better, but not odds I would bet on.

The next chart is the Dow going back to 1900 on a quarterly basis and displaying all rallies following a quarter end declines of 20% or more. ***MOST IMPORTANTLY is that when you have a rally of 60% or more there has ALWAYS been a decline of 20% or more BEFORE the advance.*** The real concern should NOT be if the market can advance from here but whether or not there is a permanent impairment to your investment capital looming. If you will notice in the first chart above the BIGGEST rallies followed the biggest declines. Very rarely did you have a big advance following a big advance. Could it happen? Sure, anything is possible but statistically the odds really aren't in our favor.



The Reasons Why It Most Likely Won't Happen

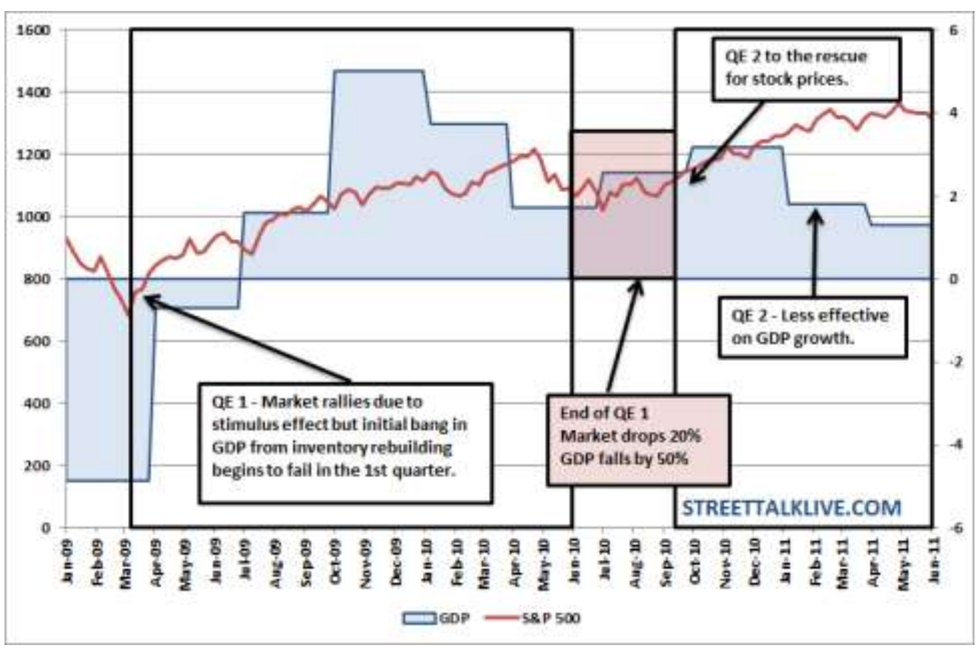
James lays out 10 reasons why the Dow will rally to 20,000 in the next 12-18 months and since there is some overlap between them we can consolidate them down into a more focused list of the hurdles that will be met.

1) *"QE2 has not started. WHAT? You might say? I thought not only has it started last November, it's about to end? Not true at all. Federal stimulus takes 6 to 18 months before even one dollar hits the U.S. economy in a meaningful way. So expect that $600 billion or more to start hitting toward the end of 2011."*

James is correct when he says that it takes 6-18 months for Federal stimulus to hit the economy, normally. However, what he is referring to is when the Fed lowers interest rates on the overnight lending rate. As we have discussed in the past – when the Fed lowers the overnight lending rate banks can borrow from their reserve accounts at the Fed at a cheaper rate and then loan it out in the form of mortgages, commercial and personal loans, etc. These loans are then used to build houses, start businesses, purchase inventories, consume goods, etc., which then shows up in economic growth and ultimately in corporate profits which drives stock prices higher. That cycle takes about 9 months on average from when the Fed first begins lowering interest rates.

However, Quantitative Easing (QE) is a different animal altogether and directly impacted asset prices as we detailed in our newsletter earlier this year [*"How Does QE Affect Stock Prices"*] Even "The Bernank" himself stated that one of the primary goals of the second round of QE was to raise asset prices to increase consumer confidence.

Furthermore, it is not a difficult stretch to piece together the effects of QE as shown in the chart to the right



The chart very clearly shows that both QE programs have had an immediate effect on asset prices as it signaled to market participants, primarily the major hedge funds, banks and proprietary traders, that there were very limited downside risks to taking on massive speculative exposure.

However, the economic impacts from QE have been much less impressive. The majority of the growth in GDP has come from inventory building with very little net organic growth from the consumption cycle.

So, in regards to James' view that QE is still coming in the next 12 to 18 months, if this were the case then we would just now being seeing the initial impacts on the economy from QE 1 that effectively started in June of 2009. However, we are witnessing just the opposite as GDP declines steadily as the stimulus led boost that really occurred from the start is now waning due to the *"law of diminishing returns."* When the market and the economy were completely crushed in March of 2009 the first round of QE had a net positive effect, completely artificial and unsustainable of course, but each subsequent dollar invested now has less and less net positive effect.

We will address this more in just a minute. Let's get to point two.

2) *"One major reason is because we are in the third administration of George W. Bush. The tax cuts got extended. This signaled that Barack Obama was going to pay lip service to his constituents while still keeping an eye on the stock market. The guy wants to get re-elected, after all."*

James is right. Obama does want to get re-elected. NO PRESIDENT has ever been re-elected when unemployment was above 8%. At a 9.1% unemployment rate as of last week, no job growth of any substantial amount, the lowest employment to population ratio since the early 1980's, housing in the tank and getting worse, a record number of individuals on food stamps, etc., etc., you can bet your farm on the fact that the current Administration is already placing late night phone calls to "The Bernank" to come up with the next method of injecting capital directly into the economy.

The next round of QE, in whatever form it takes will most likely come around the middle to the end of summer and will help stabilize a market that is declining and GDP that is headed back towards a secondary recession. We wrote last summer on July 17th, 2010:

"Over the last several weeks we have been laying out the case for a weakening economic environment and the potential for a secondary decline in the economy to a negative GDP growth rate. As more and more economic reports come in dismally negative and deteriorating rapidly we are more convinced this week than we were the last.

HOWEVER, last week we stated; 'Also, with the economic environment weakening rapidly we doubt that this [a rally to new highs] ***will happen UNLESS another round of financial stimulus is injected into the markets and then all bets are off.'***

This week [July 24th, 2010], we were surprised by the following statement from the Federal Open Market Committee (FOMC):

"Members noted that in addition to continuing to develop and test instruments to exit from the period of unusually accommodative monetary policy, ***the Committee would need to consider whether further policy stimulus might become appropriate if the outlook were to worsen appreciably.****"*

Of course, it was shortly after that the Fed announced QE 2 and the market began its second leg of the rally. With the economy in almost exactly the same place as it was last summer at this time and with only a little more than 12 months to go to the election – the Fed will almost have no choice but to institute another round of QE before long.

This time, however, in order for it to have any real effect it will have to be substantially larger (closer to $2 Trillion) and combined with **other programs to get the banking system back onto stronger footing such as a real push to forgive the banks of all of their mortgage fraud and a write-down of mortgage principal program with guarantees to back up second lien-holders**.

However, even with this we won't make it 20,000 in the next 12-18 months.

3) *"Multiplier effect. Once the stimulus hits the economy, it's not just $600 billion. It's probably more like $3 trillion. How come? Because when you buy that coffee with $1 at the local deli, what does that deli guy do with it? He buys a newspaper? And then that guy buys a donut. The multiplier effect is up to 10X. To be honest, I'm more worried about a bubble in 2013 then I am worried about a economic slowdown."*

Fiscal policy is a neutral, at best, multiplier of economic growth in the economy. In other words, every time the government takes a dollar and spends it the multiplier effect is 1.0, however, more likely it is much less than 1.0 and probably closer to zero. However, what do we mean by a multiplier?

In the past we have used the example of a building a house which has roughly a multiplier effect of 4.0. When you spend a dollar on building a new home it employs many, many other people from architects, to suppliers, the contractors, framers, roofers, carpenters, electricians, plumbers, etc. However, it also creates income for the companies supplying the building materials and the commodity producers as well. So, as you can see, when you spend a dollar building a home it employs many other people which terms give them income to spend in the economy which creates other jobs, so for and so on.

When the government spends a dollar on bailing out a bank, keeping a fireman or policeman employed, etc. The net effect is near zero because when that dollar is used up it creates no other organic economic growth.

My friend, Dr. Gary Shilling, in his latest book, "The Age Of Deleveraging" , which is a must read, did a great analysis of the simplified and unsubstantiated Keynesian multiplier (p.216) still taught in many colleges and universities is extremely insightful particularly since our government officials are glued to Keynesian economic theory.

"But the Austrian School of economists like Friedrich Hayek and Ludwig von Mises believed that the economy is much more complicated… The Austrian view suggests that the government spending multiplier may be only 1.0 and that there are not any follow-on effects. More recent academic studies indicate that the multiplier is less than 1.0, and perhaps much less."

After recognizing the difficulty of calculating the multiplier, Dr. Shilling writes, ***"Also, the inherent inefficiencies of government reduce the effects of deficit spending and lower the multiplier."*** Thus, if steps are taken to reduce deficit spending, the economy's growth rate will recover after the initial transitory negative impact as additional resources are provided to the private sector.

In his most recent "Insight" newsletter he also pointed out that ***"The financial sector here and overseas started to raise its borrowing in relation to its capital in the 1970s. U.S. consumers commenced their borrowing and spending binge in the early 1980s. But now both are being forced to delever, and combined with nine other economic growth retarding forces; the result is likely to be about 2.0% annual real GDP growth over the next decade."***

This is also much more dramatically shown by simple math. In the last FOUR (4) years the Federal Government has borrowed and spent $5.1 Trillion (it's actually more than that but stay with me here). The economy has grown by roughly $700 Billion. That is roughly $7 of debt and spending for every $1 of growth. Does this look like a 10x multiplier effect to you.

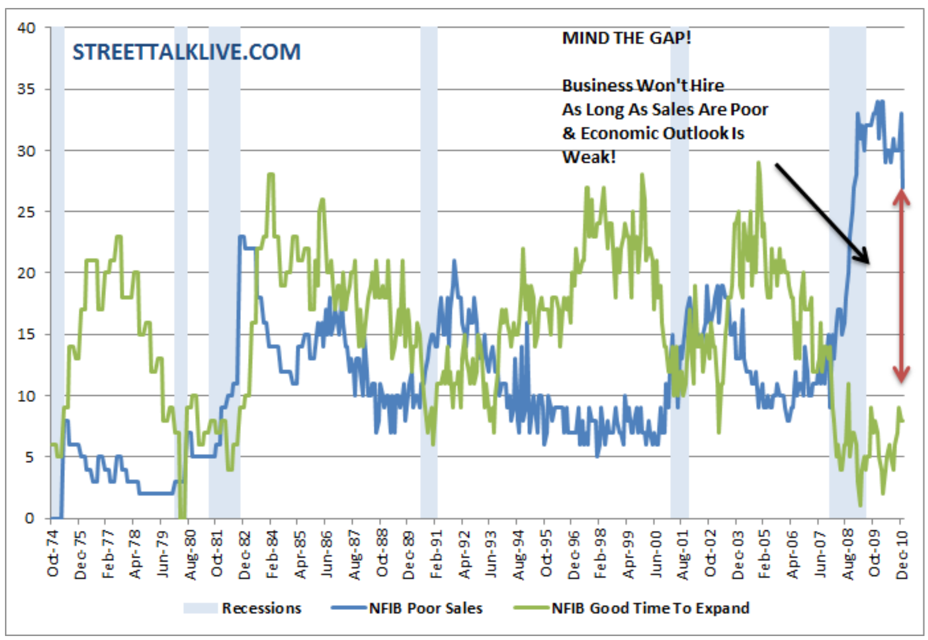
2007 Total Public Debt = $8.95 Trillion
2010 Total Public Debt = $13.53 Trillion
Plus: Deficit = $1.6 Trillion
Total Borrowed and Spent: $5.1 Trillion

2007 GDP = 14.08 Trillion
2010 GDP = 14.51 Trillion
2011 GDP = 14.77 Trillion (estimated at 1.8% current growth rate
Total GDP Growth: $700 Billion

So, let's just remove the idea of a 10x multiplier effect **"and consider this myth 'busted'".**

4 & 5) *Non-financial companies are at their highest cash levels ever. Almost $2 trillion dollars. They were hoarding the cash just **in case bad times were going to happen again**. Guess what? They didn't. But what good is that? Well…they are spending it. **Stock buy-backs are at their highest levels in history**. Let me tell you the rule of every market on the planet that we learned in Economics 101: Price is ruled by supply and demand. Demand has been down for the past two years. But that's OK, supply is now going to start going down right when demand picks up. $2 trillion is a lot of supply of shares to scoop up.*

I combined his points 4 and 5 together because they are really one point. Companies have been hoarding an excess amount of cash on their balance sheets as the level of uncertainty about future economic prospects do not warrant deploying that cash into areas the generate growth but involve risk like increasing production, expanding facilities, hiring more employees, etc. All you have to do is look at the most recent NFIB survey to figure out this problem.



As we have pointed out several times recently with most businesses primary concern being *"poor sales"*, which is the first place that an incremental demand shift will show up, and a real concern over the current economic environment making this not a *"good time to expand"* their business the cash has piled up on the balance sheet.

Furthermore, large enterprises have a tremendous bulk of that cash hoard sitting overseas with international divisions and it is NOT going to come back home due to taxation issues. This is why corporate leverage remains high and as we have pointed out in the past once you subtract the leverage on balance sheets from the cash holdings there is still a negative deficit.

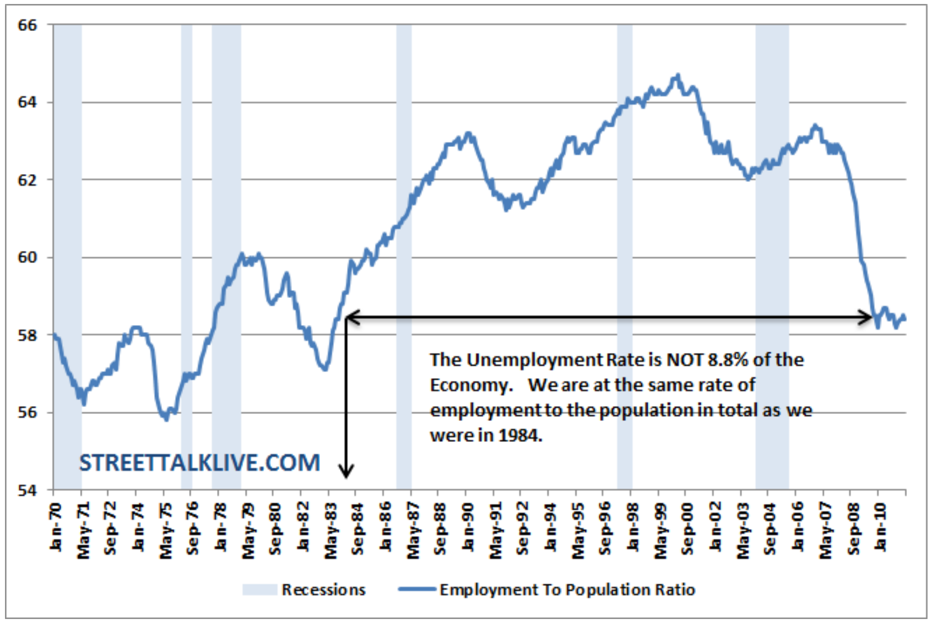
Finally, stock "buy backs" are not a good thing long term. Yes, it does reduce the amount of shares outstanding which increases the net "value" to the remaining shareholders, however, when a company is buying back its own shares at the peak of a market or economic cycle it is a signal that should be telling you that there is nothing better than can done with the money.

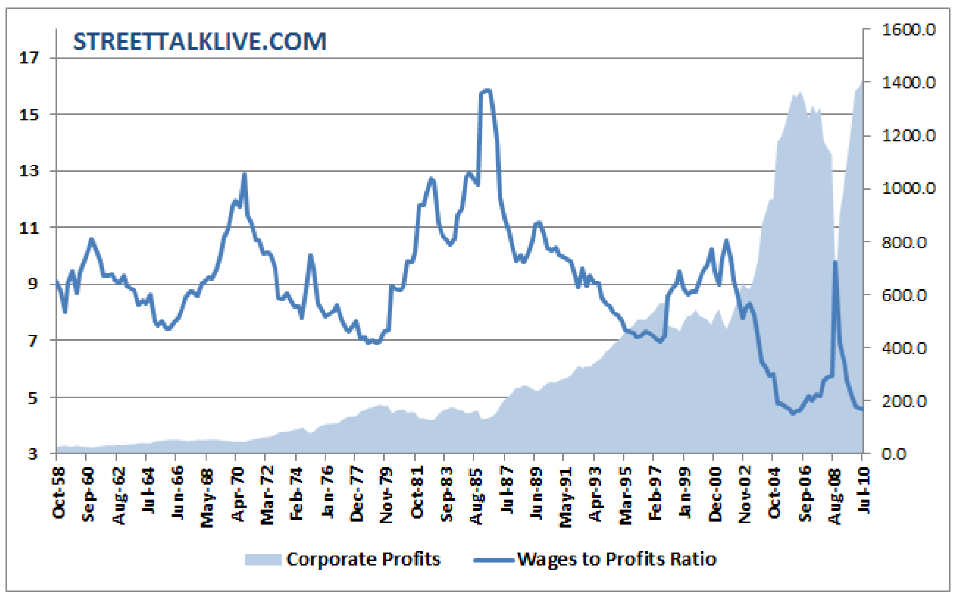
If the economy was really strong and improving these businesses would be taking these cash hoards and expanding their business, hiring employees, and deploying capital. But they aren't. Why? Because they know the same thing that you already know – the economy is weak and getting weaker.

6) *"What about unemployment? Well, according to the Bureau of Labor Statistics, temp workers are at levels not seen since before 2009. Companies hire temp workers first before they hire full-time workers. That happens in every recession in history."*

This point has been the favorite axe to grind by pretty much all of the media over the last couple of years. Yes, temporary hires are up but why? Companies hire temporary workers when demand is increasing a little but they are not sure that it is sustainable longer term. As the economy strengthens these temporary workers become full time employees. However, as seen by last week's employment report – this isn't happening.

With the economy on uneven footing and on artificial life support – small businesses (who create 70% of new jobs) are hiring temporary help because there is a massive pool of unemployed individuals willing to work part time for cheap wages. Plus with temporary help this keeps other costs down like healthcare costs and other taxes. This in turns keeps profit margins intact, especially, in the face of rising input costs.

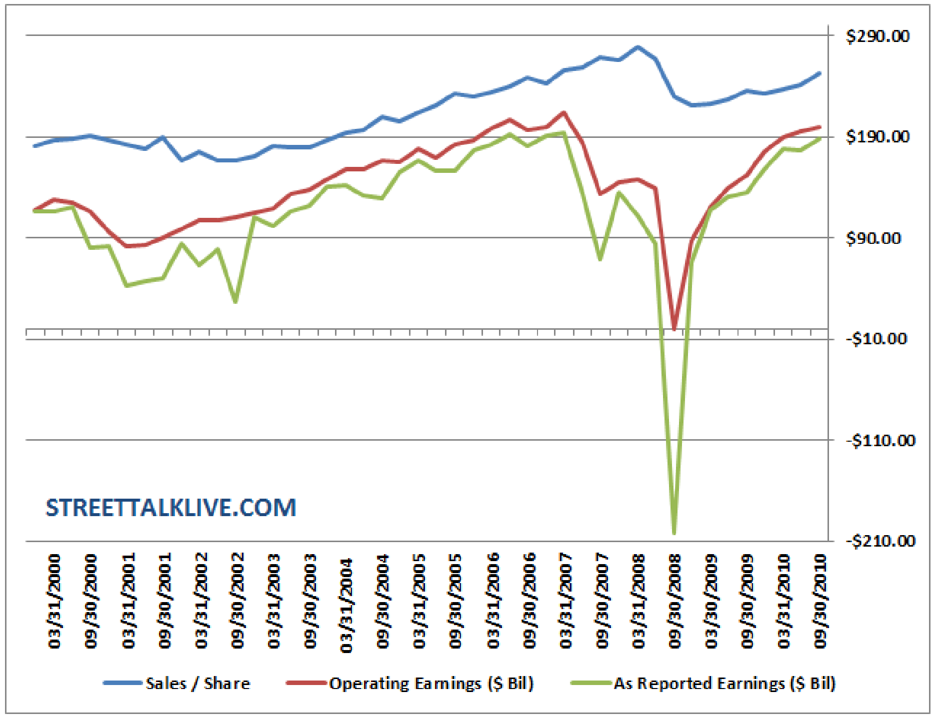




This effect can easily be seen by the level of corporate profits to wages being paid out. With an expansive available labor pool the suppression in wages will continue to a major deflationary threat on the economy as more and more individuals compete for a limited number of job openings. This in turn reduces the relative ability of individuals to increase consumption which in turn keeps businesses locked down from expanding.

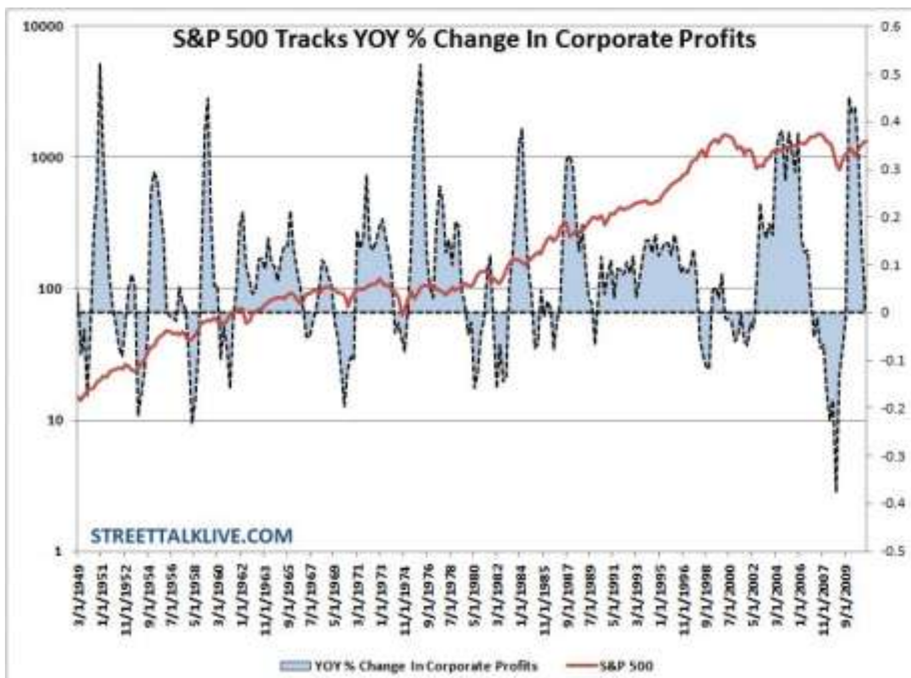
7) *"Corporate profits are at their highest levels ever. Did you know this is the first recession in history where cash levels in corporate America increased quarter-over-quarter every single quarter of the recession? And now profits are at their highest ever. Analysts expect S&P 500 earnings to come in at $95 next year. What if (as usual) they are too conservative and the number comes in at $100. Slap in a 20x multiple (could happen when the stimulus kicks in), and we have an S&P 500 at 2,000 and a Dow probably at 20,000."*

This is the real thrust of his assumption that the Dow can reach 20,000. If corporate earnings rise then the market will rise. There are a couple of issues to be had with this analysis. One is that just "slapping" slapping a 20 times earnings multiple on stocks is…well…just not smart. As we have discussed in MANY missives in the past – bull markets in stocks start with very low (below 10x earnings) multiples and generally end at 23 times earnings historically. Paying 20 times the earnings of a company has historically been a very unprofitable idea.



However, leaving that assumption aside for a second, net earnings have been rising due to cost cutting, layoffs, and other *"cuts to the bone"* type activities to keep margins growing. However, these are unsustainable and have a "diminishing rate of return" over time. As shown in the chart to the right the income from top line revenue has not grown significantly over the course of the last couple of years, relative to the massive swing in profitability, and the impact of higher input costs and a weakening economic environment will continue to pressure on profit margins.

This effect is further evident in the chart to the right that shows the recent sharp deceleration in the year over year change in corporate profits. These decelerations in profit margin growth generally precede a slowing down in the price performance of the stock market.



8) *"Major stocks are dirt cheap…These are high market-cap companies…all the major indices are market-cap weighted. So if the big guys go up, the indices go up. All of these big guys can easily double or triple."*

There is really nothing more to this statement than just wishful thinking. Most major market cap companies, once they have reached a maturity level in their business growth (like Microsoft, WalMart, etc.) cannot double and triple in value over 12-18 months. It is one thing if you have $1 million is sales and can double that – it is quite another to double or triple your sales when you are at $1 billion.

Microsoft, Intel and many others are really great companies. However, great companies do not necessarily make great stocks.

9) “*Innovation*”

Innovation is a great driver of new products. Google is beginning to really hit stride with the Android system, Apple is still changing the face of the world with its products. However, these are VERY unsustainable trends and while they may last for a year, two or even five – eventually the next “new thing” will come along. Remember Microsoft at one time was dominating the world – now that baton has shifted to Apple. However, there are VERY smart people all over the world who are innovating the next “new thing”.

The important point here is that innovation will drive a single company’s stock price higher but it will not drive the Dow 30 Industrial Stocks collectively higher. Innovation is a great talking point but has no place in the argument for driving the Dow to 20,000.

10) *“Major demographic changes are occurring that are going to affect stocks for the next 25 years. What are they?”*

Well, I can’t really respond appropriately to number 10 because he hasn’t published his thoughts. However, from a demographic standpoint the real problem that we have in the U.S. is 78 million baby boomers moving into retirement that will become net spenders versus net savers. This alone does not bode well for the markets or the economy over the next decade.

Conclusion:

The point that needs to really be made here is that it is not important whether the market goes to 20.000, 15.000, 10,000 or 5.000. The markets will do what they are going to do and you and I have no control over that. However, here is my real issue with all of this. The economy is not in good shape. You know it and I know it.

When articles like *“Dow 20,000”* are published for whatever reason, to sell a product, promote a service, etc., these individuals forget that there are REAL people reading these stories with little or no real savings to speak of and not a tremendous amount of financial education in most cases.

They then take these stories and invest their savings in the market. When the crash comes, and it always does, these authors and media analysts/commentators don’t realize the damage that they have inflicted on hundreds or even thousands of individuals.

The financial markets are not a game, a casino or a get rich quick scheme. It is a weapon of mass destruction if used improperly. **The markets require a massive level of respect for the amount of damage they can impose upon you and your family when things go wrong.** More importantly, things WILL go wrong. The markets do not always go up…and they don’t always go down. The hard part is knowing what it is about to do next.

Your long term investment horizon is only from today until the day you need your money. How long is that? 5 years, 10 years or right now. If you make a mistake and destroy a chunk of your investment capital you can NEVER recover from that decision – even if you get back to even in the next market rally you have still lost time.

It is great to promote optimism – we should all be happy, healthy, loved and surrounded by family. I am optimistic that the world will not end on October 21st of 2010 or December 21st of 2012, that you will most likely live a fairly long and healthy life and that if you treat others well – they will treat you well in return.

Telling you the market will go to 20,000 in the next year to eighteen months is wishful thinking. If you bet on it and it does; great! What happens to you, and more importantly your retirement, if it doesn’t?

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