

If There Was Ever a Time to “Go Away in May”...

If there was ever a time to “Go Away in May”, THIS IS IT! The seasonal stock buying strategy of “Going Away in May” suggests you move safely to cash or even engage in contrarian alternatives during the historically neutral season from May through October. According to Sy Harding who produces the Street Smart Report⁽¹⁾ newsletter (www.streetsmartreport.com) his Seasonal Timing System (STS), which fine-tunes the entry and exit times in and out of the market with only the two moves per year, has handily beaten the NASDAQ, S&P 500, and DJIA indexes over the past 9 years; Sy’s STS⁽¹⁾: 142.6%, NASDAQ 20.9%, S&P 500 36.3%, DJIA 72.0%. Sy sites numerous reoccurring drivers that help sustain or boost the market during the favorable season including mutual fund distributions, employee profit sharing plans, Christmas bonuses, year-end bonuses, tax refunds, Hedge fund manager fees invested, small business owner profit distributions, etc.

According to [Ned Davis Research](#) \$10,000 invested in the DOW 30 (DJIA) in 1950 for the November 1st to April 30th period each year would have yielded \$415,890 by 2001, in contrast to \$1,743 in the May to October period. The profitable period is extended to include May & October during bull markets, whereas in bear markets November & April can suffer seriously.

Others have recognized this seasonal pattern for many years as well; hence numerous trading strategies and arbitrage have been developed respecting this phenomenon.

Why is This May so Significant?

We are in a Secular Bear market, which began in March 2000 and will last a total time of approx. 12-18 years. During secular bear markets a *seasonal strategy* only becomes more significant to be safely invested or out of the equity markets during the treacherous “unfavorable” 4-8 month season.

I have written numerous missives identifying the enormous unprecedented magnitude of the aggregate bubbles in Real Estate, Bonds, and Stocks that exist in the U.S. I fully expect a global depression to begin any time between now and the end of 2010, and to last for 8-10 years. Now, for the shorter-term specific concerns:

- Next month (May) marks the beginning of another “unfavorable” season this year.
- We are firmly in the middle of our secular bear market (2000-2015?).
- We experienced a cyclical (2-5 years) bull market peak in late October 2007, and are now in a cyclical bear market, which should last a few years.
- Our illustrious central bank and Congress are reaching back to Depression times for any creative financial rabbits that might keep all U.S. bubbles including Stocks, Bonds, and Real Estate levitated a bit longer, such as:
 - FHLA Federal Home Loan Bank (FHLB); Originally set up in 1932 to stimulate mortgage lending, they’ve been energized with gusto lending hundreds of billions to bail out mortgage lenders.
 - Bailout of non-bank firms through member banks; e.g. \$29 billion of taxpayer money at risk enabling the J.P. Morgan Chase acquisition of Bear Sterns (non-bank).
 - Term Auction Facility (TAF); Swapping Treasuries for questionable quality debt. These repurchase (RP) transactions are expected to cumulate to more than \$100 billion +.

- Term Securities Lending Facility (TSLF); Enabling 20 securities firms (non-bank) to borrow up to \$200 Billion secured by questionable collateral.
- The most aggressive Fed Funds rate cuts in a quarter century (5.25% to 2.25% in only 2 months).
- Aggressive Fed Discount Rate cuts along with the encouraged use of the “Discount Window” facility because banks traditionally suffer a negative stigma from its use.
- Fannie Mae and Freddie Mac; Initiative to provide up to \$200 billion liquidity to the mortgage market. “.... should allow the GSEs to purchase or guarantee about \$2 trillion in mortgages this year.”⁽²⁾
- Foreclosure Prevention Act; Another \$30 billion for tax breaks and direct subsidies.
- Etc., etc., etc....

THESE INITIATIVES CLEARLY ANNOUNCE THAT OUR CENTRAL BANK WILL DO **ANYTHING** TO FLOOD THE WORLD WITH LIQUIDITY AND SACRIFICE THE DOLLAR TO PREVENT A DEFLATIONARY COLLAPSE. Unfortunately, any significant holder of dollars and dollar-based assets will continue the process of diversifying away from the embattled currency as soon as possible. This action will harm nearly all U.S. financial nominal asset valuations in the near term. Hyperinflation will then follow the collapse of the dollar.

- The U.S. is in a recession and by all rational accounts will get worse as the year progresses. Hence a Democratic presidential victory is likely, which will not be favorable for equities as both Democratic candidates are rattling the “tax increase” swords.

Are Current Stock Overvaluations Illusions of Wealth or Simply Optimistic Projections?

The “Austrian Enginomic” logic recognizes there is a fundamental value of all businesses in aggregate that can only increase from aggregate employment hour and productivity increases, which have both totaled approx. 3% per year over the past 55 years. Any aggregate equity price growth greater than the 3% plus inflation is in bubble territory. Further, the “Enginomic” logic asserts that busts are the result of the eventual DISCOVERY of said bubbles. In contrast, most economic theorists and analysts explain a potentially overvalued stock market as having optimistic future earnings expectations that they expect will materialize. Of course, in time the market may discover the earlier earnings projections were too optimistic and the rosy predictions simply did not materialize. There would **not** be an admission the initially bloated prices were bubbles or illusions of wealth. In stark contrast, the Enginomic logic recognizes these high valuations in aggregate are in fact bubbles or illusions of wealth, which when discovered will either bust or be diluted by easy-money central bank policies to debase our currency (inflation) and keep the bloated nominal stock prices from crashing.

What is a Realistic Rate for the Aggregate Stock Valuation Increase?

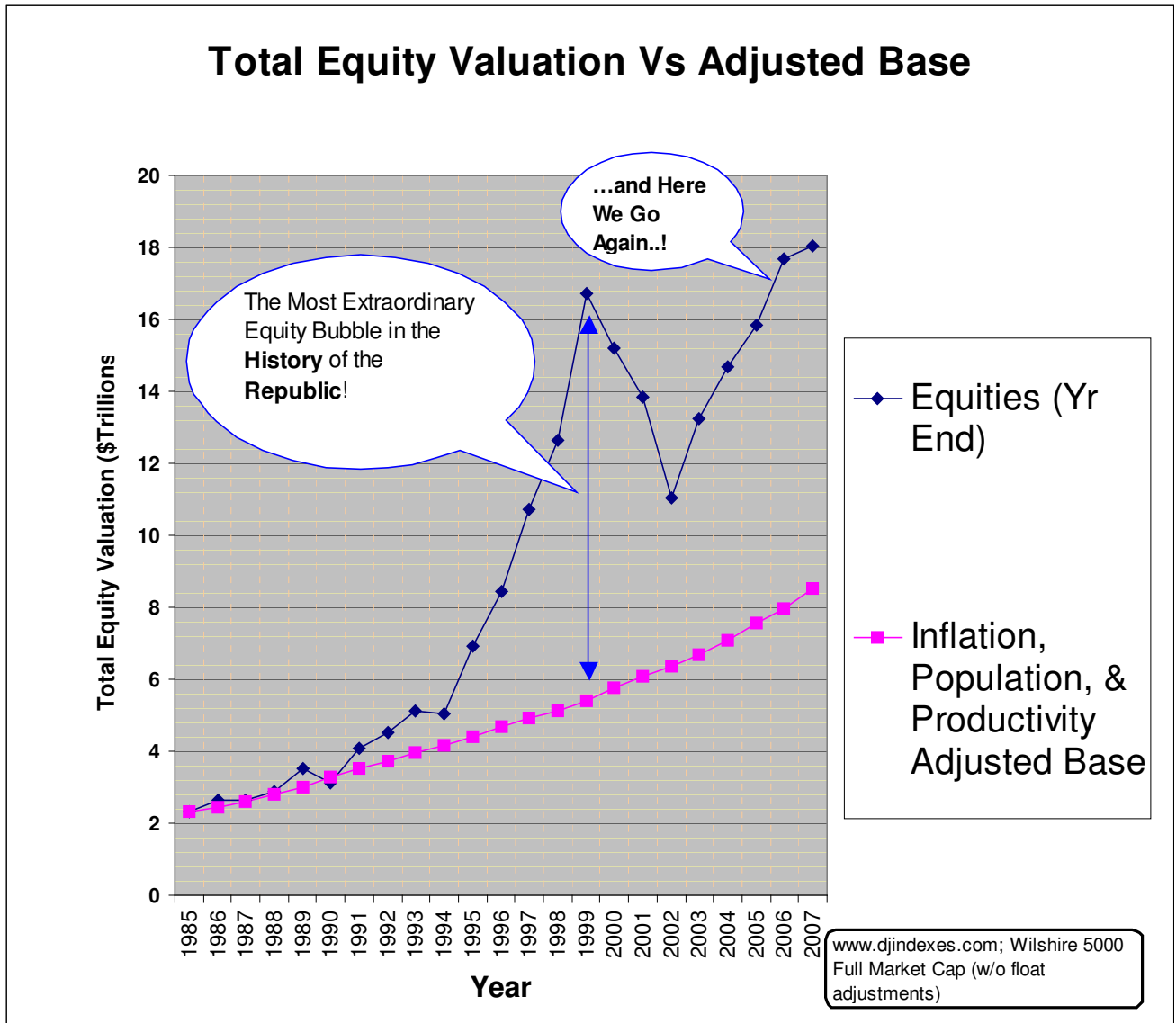
In the “Real Economy”, if we lived within a real money (e.g. gold-backed currency) rather than a fiat currency system, the total stock market would only increase in value by the rate of the employment hour’s increase plus the rate of productivity increase, assuming the credit markets are neutral. There are no other fundamental drivers that can grow real company valuations in aggregate. Hence a realistic employment hour increase of 1.0% annually in addition to a strong 2% productivity increase in an industrialized country yields 3.0%. With “0” inflation, the Dow Jones would logically increase approx. 0.01% per day, or at today’s level of 12,800 it would rise a boring 1.5 points per day! Add a 3% annualized rate of inflation and the DJIA number doubles to a blistering 3.1 points per day!! This gives you a sense of how volatile and potentially puffed our markets are today and how conditioned we have become to expecting 100-200 point moves hopefully in the UP direction. A DISCONNECT??

If one accepts that all business are made up of Capital Stock and Human Capital which can only grow from work activity (i.e. one cannot “will ” real wealth into existence) at the rates noted above, then an increase of one companies’ stock or a narrow sector of stocks must be accompanied by a commensurate **decrease** in all other stocks in aggregate as the real aggregate wealth increase will not be any greater than the noted 0.01% per day. It is a “zero sum game” as some would say. The assumption in this analysis is that there is not a significant structural shift of another major asset category such a real estate or bonds into stocks. If anything, the opposite has happened in recent years; the asset valuation shift has been into real estate and bonds; hence real stock valuations should have declined to some extent.

As an example, if I were the CEO of a “growth” company and announced a miraculous new product idea to the public that we have been developing and expect wonderful results, then my company stock may well respond positively pushing my P/E ratio up correspondingly. Again, assuming a gold currency standard, any real money that shifts into purchases of my company’s stock must have an accompanying reduction on other stock valuations in aggregate. **One cannot will wealth into existence;** hence, if the market pricing is accurately reflecting aggregate business valuations, it must NOT increase in aggregate simply from my announcement. Now, as my idea becomes implemented and the productivity of my company increases as a result of this new product displacing some other product in the market, then the aggregate valuation of the entire market would rightfully increase at the rate of the noted productivity increase **WHEN it ACTUALLY OCCURS**. In that case earnings would rise at the same rate as the productivity increase resulting from the new product, and it would warrant the company valuation to rise as well. Hence, if the new idea which pumped my stock price up at the expense of all other stocks becomes a successful hit, then the real earnings would rise eventually justifying the initial stock price increase. In aggregate as real earnings increase in my company or any number of companies that advance productivity, then the aggregate stock valuation would justifiably increase at the same rate, **BUT NOT BEFORE THE REAL PRODUCTIVITY IS EXPERIENCED!**

How Much are Stocks Overvalued?

I have graphed on an annual basis the actual valuation of the Wilshire 5000 index, which reflects the total U.S. stock market capitalization. I have also graphed a valuation based upon population, productivity, and inflation to represent a “fundamental” valuation for the Wilshire 5000. The gap between the two lines represents the size of the bubble or illusory wealth in stocks today. If the Bureau of Labor Standard’s inflation calculations were accurate, the gap would be narrower, but stocks would still be vastly overvalued.



Why Do Stocks Become Overvalued?

The “Financial Cartel” which includes major banks, Wall Street’s brokerage firms, hedge funds, private equity funds, Agencies (GSEs), and our Federal Reserve Bank wants stocks to go up! They have a powerful self-interest in seeing that their fortunes are realized. If they have the power to move markets in any manner, then they will! If they can profit from extreme volatility, then we will experience extreme volatility. Since they are generally injured from the market dropping steadily in nominal terms, they will do everything in their power to prevent it including liquidity injections (money and credit) far greater than real output increases would justify, and shifting market risks to government.

Realizing that the real wealth of companies moves at the pace of a snail (0.01% per day), if the stock market suddenly rises 5% in one day, it is not possible for that meteoric spike to represent an accurate real value change of the markets. In this case Wall Street will spin the sudden increase as a justified recognition of value that was not recognized yesterday because markets are “efficient” and moved quickly based upon new information. Accordingly, a 5% drop in the market one day does not reflect a real wealth decrease of 5%. In that case Wall Street will spin the sudden drop as an “aberration”, and a recovery will be just a short time away back to “legitimate” market-efficient levels. What nonsense! The stock market behaves like a bumblebee on speed moving erratically in all directions manipulated by unknown sources, which have hidden agendas. We have an extraordinary DISCONNECT between the “Real Economy” and the “Financial Economy”!

What will Happen to Stocks When the “Masses” Discover the Illusion of Wealth?

The greatest series of market crashes that we’ve experienced in history. I expect we will experience them over the next 3 years.

Conclusion

Go away in May!!! I believe the U.S. equity markets are extremely vulnerable to crashes especially during the unfavorable seasons for the next **three** years through 2010. The markets have been manipulated into a monstrous bubble. Our central Bank and government have made extraordinary efforts in keeping the bubbles aloft. Unfortunately, when the masses throughout the world holding dollars and dollar-based assets discover the horrendous illusions of wealth, they will be merciless in dumping the assets because of their widespread fear of losing their perceived wealth.

By: Russell M. Randall 4-23-2008
Home Page: www.austrianenginomics.com

References:

- (1) Street Smart Report is a newsletter produced by Sy Harding. The Seasonal Timing Strategy (STS) description and data can be found on his website here.... <http://www.streetSMARTreport.com/sts.html> Data taken on 4-23-2008.
- (2) From the Office of Federal Housing Enterprise Oversight (OFHEO) which oversees operation of Fannie Mae and Freddie Mac. Announcement made on 3-18-2008.