DJC

THE DAILY JOURNAL OF COMMERCE, PORTLAND, OREGON

MONDAY
March 12, 2007
www.djcOregon.com

Reprinted from the Daily Journal of Commerce.
To subscribe, e-mail subscriptions@djcOregon.com.
©Daily Journal of Commerce. All rights reserved.

In Year of the Pig, beware a slaughter

Happy Chinese new year. It's the Year of the Pig. The Year of the Golden Pig, actually, which is why so many Chinese couples are hoping for a child this year, believed to be an especially auspicious one.

But remember the old Wall Street saying: Bulls make money, bears make money, and pigs get slaughtered.

Indeed, the Shanghai stock index rose a remarkable 130 percent in 2006 and 174 percent since mid-2006, reaching record highs. But one day after reaching a record high, the Shanghai Composite Index fell 8.8 percent, its largest drop since Deng Xiaoping died. Profit-taking or something more?

World markets responded accordingly, as indices fell broadly. Asian markets all lost ground, ranging from Japan's 0.5 percent loss to a 2.8 percent decline in Malaysia. European markets were down from 2.3 percent in the United Kingdom to 3.02 percent in France. In the United States, the Standard & Poor's 500-stock index was down 3.7 percent, and the Dow was down 3.29 percent. Volatility, which had been low, jumped. One wonders why such a small market mostly owned by Chinese locals would cause a drop not seen since September 2001 in the developed and liquid markets of the world.

Chinese banking officials have had a wary eye on the run-up in stock prices, and although they have not changed interest rates much, they have tightened reserve requirements at banks in order to soak up some of the excess liquidity that has been feeding the Chinese economy and stock market. And with the Chinese legislature scheduled to convene, there were rumors that China would impose a tax on capital gains.

Commodity prices and stocks of commodity companies fell sharply as concern rose that a slowing Chinese economy would mean lower demand for commodities. Sub-prime lending worries continued to haunt the U.S. market, as did the ghost of former Federal Reserve Chairman Alan Greenspan.

Greenspan, playing King Kong in Hong Kong, predicted a looming recession in the United States, but – as usual, keeping a foot firmly planted in both camps – he went on to say that most forecasters were not making that judgment. Days later he reiterated his views, saying that the United States had a 33 percent chance of a recession. In the meantime the financial press reported that economists almost never correctly forecast recessions. Of course, if the United States were to experience a recession, the rest of the world would suffer, and so Greenspan's remarks, coming as they did from Hong Kong, added fuel to an already raging fire.

SUMMING IT UP

William Rutherford

To be sure, leading indicators are trending down, and corporate earnings appear to be decelerating, causing a reduction in capital spending. Durable goods orders declined 7.8 percent in January; the NAPM-Chicago purchasing managers' index dropped to 47.9 percent, signaling a slowdown. Prices of existing homes fell 0.7 percent, and sales of new homes dropped 16.6 percent.

So, was this merely profit-taking or the harbinger of something more serious? Only time will tell, but this is the kind of "financial accident" that I have warned of previously. Sometimes, when these events occur, it takes time for the ramifications to surface. Not only could this market drop presage troubles in China, it could take some of the sheen off the booming Asian economies, as well as Chinese trading partners.

Oregon should take notice of any Japanese slowdown, as recent figures show that China has vaulted to our No. 2 trading partner, growing at a faster rate than any other nation.

While we are discussing international markets, it is worth noting that the European economies have been picking up, closing the gap with growth in the United States. Germany has become the fastest-growing economy in the G8, expanding 3.7 percent last year compared to 3.4 percent in the United States and 3 percent in the United Kingdom. Even more remarkably, this growth has come while the European Central Bank seems oblivious to the economy and the German government, committing one of the cardinal sins of economic growth, is raising taxes in order to cut budget deficits. Indeed, Italy had a growth boom with a 4.5 percent annualized increase in the fourth quarter of 2006, as the Italian government introduced the biggest tax increase in its history. However, Europe was the beneficiary of a strong euro relative to the U.S. dollar and received an extra dividend when oil prices, which are priced in dollars, fell. The benefit of lower oil prices seems to have outweighed the tax increases.

It is also worth noting that the yen has appreciated about 2 percent. Could this be the beginning of a slowdown in the export of Japanese capital? If so, that also could argue for a global slowdown.

After an extended global run-up in equity prices and economic growth, a correction was to be expected, but the timing was not. However, my earlier columns and client letters placed the slowdown early this year. I anticipate that the next several months will be trying for the economy and investors; that inflation will remain constrained and the price of oil will pull back (exogenous evens can change this outlook quickly); that the Fed will cut interest rates at least once this year, probably in the summer and maybe again before year end; and that this scenario will see an economic and market recovery later this year.

Indeed, Legg Mason Capital Management, in researching past market performance, reported in the March 3-4 Wall Street Journal that, when all stock market indices fell by 3 percent or more in the same day, each index was little changed one month later, but one year later had gained at least 14 percent.

Gung hei fat choi!

William Rutherford is the founder and president of the Portland company Rutherford Investment Management, listed in Barron's as one of the leading separate account managers in the country and recipient of a five-star rating from Morningstar for its three- and five-year returns. He is also the author of a critical appraisal of Alan Greenspan's term as Fed chief, "Who Shot Goldilocks?" Contact Rutherford at 888-755-6546 or on the Web at www.rutherfordinvestment.com.