IS THE STOCK MARKET RALLY RUNNING OUT OF GAS?

The major central banks, the U.S. Fed, the ECB and the Bank of Japan have all pledged to provide liquidity as far as the eye can see. The only problem: it hasn't worked. So either it has backfired and actually subdued economic growth, or as Nobel Laureate Paul Krugman would say, they haven't done enough.

At Dohmen Capital, we don't agree with the Krugman theory. If something hasn't worked for five years, in various economic zones, it seems to be a good clue that it's the wrong medicine. Call the doctor!

The ECB decision in mid-March created a "risk on" attitude of the big money managers, with renewed optimism. The markets rallied sharply, for a few days, the shorts were squeezed even further, and fears temporarily dissipated. But it didn't last. The problems are so much bigger.

The ECB is now actually paying banks to make loans, but the banks apparently don't have customers who want loans. Years ago, we called that "pushing on a string." In other words, the Fed pushes the money into the banking system, but they can't force the banks to lend it.

The ECB move also squeezed the oil shorts, and shorts in commodities, as if the ECB move would cause a global bull market. How naïve! The resulting rallies were sharp but very short, lasting about three days. Then the sellers took advantage of the higher prices and sold, pushing them down sharply.

I always recommend that when you listen to an analyst speaking about a stock, the market, or a commodity like oil, look at the chart.

I have seen a number of bear markets over the past 40 years, and even more bear market rallies. They are usually sharp, and usually produce new bulls. They usually don't stop until the bears have been discredited, or at least have been challenged.

In the end, such bear market rallies always fail. But they can be profitable for those who can act quickly, going in for the rally, and then going short for the next decline. But you must have good guidance on the timing. It can only be done successfully with advanced technical analysis, and even that is not a guarantee.

The upside potential of the major indices is now limited because of the very big resistance levels above, unless there is a big surprise by the Fed. There could be something brewing in the halls of the Federal Reserve, judging by the unusual televised conference of former Fed chiefs together with Janet Yellen last week, yesterday's meeting at the White House between the president and Yellen, and the extraordinary meeting of the Fed on April 12.

So far this year, most of this rally is artificial. It's been a rally of the walking dead. In other words, the stocks with the biggest gains are those with the poorest fundamentals. It's been a case of 'smoke and mirrors.' While stocks and indices have rallied, corporate profits have been declining rapidly. Expectations for rising GDP have diminished, with the Atlanta Fed now forecasting a measly 0.1% rise in the first quarter.

Stock buybacks of companies are already at a record high. In fact, buybacks are virtually the only source of meaningful buying except for short covering. According to Bloomberg.com, stock buybacks of S&P 500 firms may be $165 billion this quarter. That would be close to the record of 2007.

Investors in mutual funds and ETFs withdrew $40 billion since January. This is close to a record for one quarter.

If buybacks slow because of diminished profits, the rally is over, and the bear market will resume with vigor.

What could cause that? Companies will have to preserve cash as profits turn to losses. Corporate profits have now declined for four consecutive quarters, which usually precedes a recession. But Wall Street analysts say “it’s just a profit recession,” as if it is not important. For me, it’s the most important.

Companies will be careful not to add to the big losses they already have for the stocks they bought over the past two years. Cash flow should be used for more productive things, like R&D, or capital investments. Almost nothing has been spent on that for years.

While companies have been buying their own shares, the outflows from the stock market are significant. That creates a demand vacuum underneath the price. And vacuums are always eventually filled on our planet, in this case, by the stock market declining.

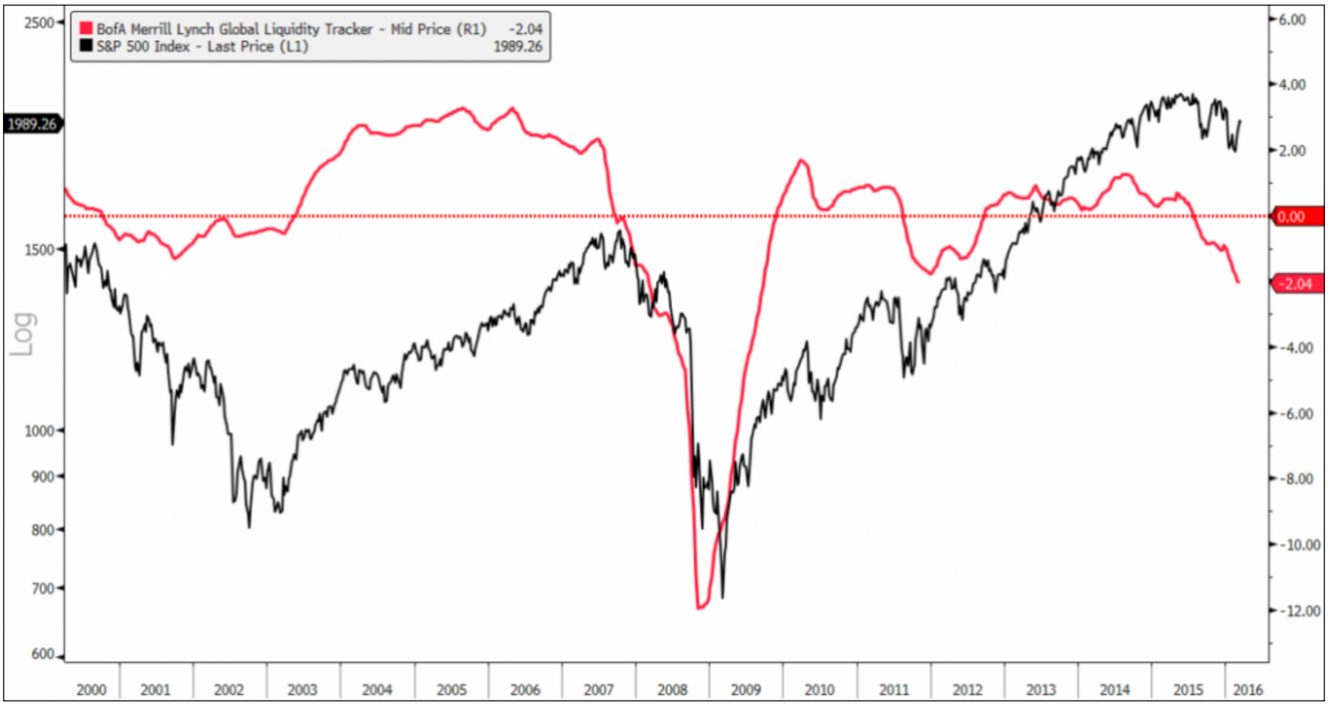
No new money has been added to mutual funds and ETFs since before the last financial crisis according the Liz Ann Sonders, financial strategist of Charles Schwab. She didn’t point out that since that crisis, not only have investors not bought stocks, there has been a huge liquidation of investments by the public. Stock market money is needed to pay the rent, the mortgage, the high cost of living, the college tuition for the kids, and higher taxes.

The “golden goose,”–the hard-working people that make the country work–have been squeezed and squeezed by the elitists in government. Employees have not had a pay increase (after inflation) for about the last 20 years. Yet prices and taxes continue to rise. The golden goose is now in critical care. But hard working people are outnumbered by those who find it more comfortable not to work and just depend on checks from the government.

Many years ago, in the early 1970s I developed what I call my “Theory of Liquidity & Credit.” It was based on observations and analysis. It says that the primary determinants of major stock market trends are changes in liquidity and credit. All the other economic factors are lagging indicators and are dependent on liquidity and credit. If that theory is valid, then we can save a lot of time looking at dozens of economic statistics and instead use them as confirmation.

So what is liquidity doing now? Here is the chart of the Merrill Lynch Global Liquidity Tracker (red line) and the S&P 500 index, (black line). It spells “DANGER.” It is now at a level of 2008 when it was also declining and resulted in the global crash.

Such a decline in liquidity is eventually and inevitably followed by a decline in the stock market. The bear market rally is like a car still moving after you have run out of gas. The momentum keeps the car going for a while. And then it stops. If you were going up a hill, you would start rolling backwards.



And that's what will happen to the stock market once the buybacks stop. However, we must never get complacent with any scenario because the world is dynamic. I always stay alert to any potential changes in the environment that could change the outlook.

After the Fed meeting on March 16, I wrote that on the S&P 500, the 2,080 area would be the next target. On April 1, the S&P hit 2,075. If that is the rally top, it was made on April Fool's day, which would be very appropriate. Be careful.

Wishing you successful investing,

Bert Dohmen,
Founder Dohmen Capital Research, Inc.