

# June Swoon Nixes Honeymoon

## Market Summary

June 2008

As he signed an historic two-year \$160,000 contract in the spring of 1930, Babe Ruth was asked how a baseball player might be paid more than the President of the United States. His famous reply: “I had a better year than he did.”

That story likely was embellished by news reporters of the day, but there is no question that President Herbert Hoover, and the nation he led, had had a decidedly lousy year in 1929, when Wall Street, one Black Thursday in October, notoriously laid an egg. But 1930, the launch year for the Great Depression, would be lousier still, and unfortunately it is there that we must look to find a month of June more brutal for the Dow Jones Industrial Average than the one just past.

The DJIA slid 10.2% last month, versus a June swoon of 13.7% in 1930. The index ended that unlovely month 78 years ago at 222.46, about 42% below the all-time peak of 381.17 it had set September 3, 1929. The death march would continue until July 8, 1932, when the Dow found bottom at 41.22, 89% below its peak value.

The DJIA today is very far from such catastrophic losses, but its closing mark last month (11350.01) was 19.9% below its all-time record set October 9, 2007. That had talismanic significance for market technicians, as a decline of 20% from a high water mark is taken as a signal for a bear market.

The index slipped below the magical minus-20% line in intraday trading June 30, and market bulls spent the rest of the day struggling to nudge it back the other way, lest the quarter end under an evil portent. A “rally” just before the bell eked out a 4.4-point gain, which was enough to clear the hurdle with an angstrom or two to spare. However, so much effort for so pitiable an advance might itself be taken as signal of weakness; the market’s bears quickly reasserted themselves, and had their bad news indicator back in place shortly after the calendar turned to July.

Numerology aside, it is not difficult to impose a gloomy interpretation on the whiplash turnaround the market executed from mid-May to the end of June. Left in the lurch was a modest but promising

advance that as late as May 19 had the DJIA sitting on a 6.2% quarterly gain, which then dissolved into a 7.4% loss.

U.S. stock indices were buoyed early in May by consumer splurge-spending following the distribution of “stimulus” tax rebates. Aggressive rate cuts and other pro-growth exertions by the Federal Reserve earlier in the spring also continued to help keep equities aloft. However, by the end of June these effects had dissipated long since, like the sugar-induced surge from an “energy” drink that is followed by deeper torpor.

Or, more simply, the honeymoon had ended.

## Trouble for Stocks

Among the myriad problems bedeviling the world’s equity markets, inflation is the most ominous and the most universal. Serious inflation problems are now rampant among non-oil-exporting countries, and, by no coincidence, every major stock index fell during June.

The Federal Reserve’s Open Markets Committee, meeting June 25, left the Fed Funds rate at 2%, but made it clear in its post-meeting statement that the threat of inflation—and the expectation of inflation—had become more prominent on its worry list. That had the effect of pleasing no one. Advocates of an accommodative rate policy (e.g., former Labor Secretary and current blogger Robert Reich) castigated the Fed for ignoring economic stagnation arising from the crisis in the credit markets, loss of jobs in the economy and deflation in housing prices. At the same time, advocates of rate discipline—from the Financial Times of London to the Governor of the Central Bank of Australia—blasted the Fed for ignoring inflation not only in the U.S., but also among emerging nations that follow U.S. interest rate policy and are suffering double-digit inflation.

## Evidence: The Economy

Both sides in the argument have plenty of evidence. Non-farm payrolls shrank by 62,000 in June, according to the Labor Department. May also had a drop of 62,000, and April 67,000, according to revised figures. The revisions added 52,000 to the total of jobs lost. The reason for the

shrinkage is readily found: U.S. manufacturing is “stagnant” (except for exports) and the services sector is contracting, according to the Institute for Supply Management. The manufacturing sector registered a 50.2 mark in June, up from 49.6 in May (a mark above 50 represents expansion). Any up tick is welcome, but the ISM attributes that figure to a boom in exports due to the decline of the dollar. The service sector index meanwhile dropped in June to 48.2 from 51.7.

U.S. housing price reports again showed a record drop—15.3% in April, compared to a year ago—says the S&P/Case-Schiller index for 20 major cities. The index data show that residential property has fallen back to 2004 price levels. Commerce Department data show housing prices dropped 5.7% in May, and sales fell 40.3%, compared to May 2007.

The Consumer Confidence Index plunged 13.25% in June, to 50.4, the Conference Board reported. Worse, the board’s Expectations Index fell to an all-time low of 40.1, from 47.3 in May.

### **Evidence: Inflation**

Crude oil futures rose 38% during the second quarter, to about \$140 a barrel, according to the Wall Street Journal. Corn rose 28%, setting a new high of \$8 a bushel; soybeans jumped 34 percent. That is causing inflation problems even in countries where the currency has been appreciating, such as China and euro zone.

The Fed is becoming increasingly isolated in its interest rate policy. Two days after the June FOMC meeting, the Central Bank of Europe raised its core rate by a quarter-point, to 4.25%—a gaping 225 basis points above the Fed Funds target. Merrill Lynch has estimated that three-fourths of the world’s central banks have tightened policy by raising rates or increasing bank reserves.

The International Monetary Fund now sees the global situation as “a picture of the world in crisis,” Managing Director Dominique Strauss-Kahn recently told a press conference. Even more chilling was a declaration in the annual report of the Bank for International Settlements—the world’s central bank for central banks—that the global economy was close to a “tipping point” at which inflation could lop over into its more-feared

mirror image, deflation. The prescribed remedy: higher interest rates.

However, the Fed has not committed itself to following the world trend toward tightened policy. The statement from the June FOMC meeting cited a higher risk of inflation, but also expressed the expectation that rates would moderate in coming months. There was no mention of a shift in policy bias toward inflation protection.


Inflation in the U.S. has been no more virulent than reported in countries with higher interest rates, by official data. The unadjusted CPI in May was 2.52%, annualized, vs. 3.3% in the UK (5% interest rates) and 4% in the euro area (4.25% rates). The “core” consumer expenditure index (ex-food and energy), oft-cited in Fed reports, showed a year-over-year rise of 2.1% in May, a smidge above the targeted range of 0-2.0 percent.

### **Equities Uniformly Down**

The DJIA was the worst performing among all stock indices, but, uncharacteristically, it was followed closely by the MSCI Emerging Markets Free Index, which lost 10.0 percent. The S&P 500 lost 8.4 percent. Growth stocks fared very slightly better than either value or general indices. The Russell 2000 Growth Index dropped 6.0%, the best June performance among equity benchmarks.

### **Bonds Steady; REITS Down; Commodities Up**

Bonds behaved like a proper safe haven in June. The Lehman Aggregate Bond Index dropped 0.1%; the Long-Term Government Bond Index rose 1.5%; Lehman 1-10-year TIPS gained 1.7%, best among bond indices. In keeping with an environment of rising inflation expectations, the Citigroup High Yield Index lost 3.3% in June, worst among bond indices. The NAREIT (All REITs) Index dropped 11.3 percent. The Goldman Sachs Commodities Index rose 9.2 percent.



*Dennis Hannon*  
New Markets Analyst  
Hammond Associates  
101 S. Hanley Rd, 3<sup>rd</sup> Floor  
St. Louis, MO 63105  
314-746-1600

[www.hammondassociates.com](http://www.hammondassociates.com)

Copyright © Hammond Associates, 2008. All rights reserved