

July Brought Comeuppance

Market Summary

July 2008

There was plenty of the familiar bad news in July—employment and housing-price data were dismal; crude oil prices bumped up against \$150 a barrel. But (touch wood) there were also signs in July that the markets were getting bored with their own bad behavior. Economic data deriving from the winter and early spring (employment; housing prices) stayed on their downward paths, but some numbers based on forecasts of coming events (energy futures; financial stocks) gave cause, if not for optimism, at least for a guarded smile.

July was a “comeuppance month” for hedge funds that stayed too long with the highly lucrative strategy of betting on the continued rise energy prices and descent of financial stocks, a fund-of-funds manager told the Wall Street Journal. So strongly correlated had these trends become that some speculators apparently began to believe they were causally related. The market often deals harshly with such mistakes, and these would-be wizards were whipsawed viciously.

Hedge funds are the centurions of market efficiency, and not infrequently go in harm’s way in pursuit of pricing anomalies. This particular fracas—between the energy and financial sectors—is more than a little risky, however. It’s a bar fight, in the words of the Wall Street Journal, and those who venture near might well emerge with eyes blackened and nostrils askew.

In truth, the reversal of oil prices in July, though sharp, does rise to the standard of a genuine turn in the market. It did prove, however, that the price of crude is not unidirectional: It can go down. The laws of probability therefore require that it will start down one day, and that day might well look much like July 11, when crude mounted a charge on \$150 on the New York Mercantile Exchange, only to sputter out at \$147.20. It then declined to close the month at \$124.08, 15% below its top. In the preceding 12 months, crude had closed an average of only 4.2% below its intra-month high. The July close also was 16% below the close for June, whereas the 12 preceding monthly closes had averaged a 13% increase.

Of themselves these market data mean next to nothing, but there are fundamental reasons to suspect that oil prices might be approaching at least a temporary top. U.S. drivers cut down on their miles driven by 3.7% (more than 40 billion miles) for the seven-month period ending in May, according to the Department of Transportation. This is the first reduction in mileage since the oil shocks of the 1970’s, when severe shortages, along with violently rising prices forced cars off the road. This time demand dampened spontaneously amid ample supply, which according to the economics texts means prices will come under pressure.

An increase in supply also is at least foreseeable as oil-bearing sands in Alberta have come into development, a rich oil strike has been reported in the South Atlantic and even the United States might resume offshore exploration (President Bush and both presidential candidates have endorsed it, with varying degrees of qualification).

Pushy Inflation

Energy price increases already in place are still working their way through the economy. Consumers are facing the full brunt of cost-push inflation, now that the \$90 billion “stimulus” tax rebates have been distributed and turmoil in the credit industry has tightened access to money. Economists are forecasting a decline in consumer spending, which accounts for 70% of the GDP. Employers, well aware of these projections of slackened demand and faced with their own cost-push problems, also are stretching their dollars, including wage dollars.

One effect of all this price consciousness is that the Federal Reserve has demoted inflation risk back to an equal rank with “the downside risk to growth” (i.e., recession) in its official remarks issued after the meeting of its Open Markets Committee in early August. Just five weeks before, the FOMC had declared inflation to be the top economic risk. The new phrasing is taken to be a clear signal of a reduced likelihood of a near-term hike in interest rates.

Consistent with all of this, initial claims for unemployment benefits rose in July for the sixth

straight month, reaching 450,000, according to the Department of Labor. That is the highest figure since March, 2002, and represents an increase of 7,000 claims when the consensus expectation was a decrease of 20,000.

Employers apparently are coping with less manpower, as productivity—output per hour of work—rose 2.6% in the first quarter, and 2.2% in the second, the Labor Department reported. Although likely due in part to job reduction, this is a welcome anti-inflationary factoid. Higher productivity is the only means of stifling cost-push inflation, or, in the long run, of providing real increases in wages.

Home prices declined 16.9% in May, setting still another downside record for the S&P/Case-Schiller Index. However, fixed investment for residential housing fell less in the April-June quarter than it had in the first quarter (15.6% vs. 25.1%)—a tidbit for resolute optimists. One more (relative) up tick could be called a trend.

Consumers remain glum. The Conference Board's consumer confidence index registered 51.9 in July, up marginally from 51.0 in June (1985 = 100). In January 2000, the index stood at 144.7. It is to be hoped that consumers are as wrong now as they were then.

The most non-committal July datum came from the Institute for Supply Management, which reported its manufacturing activity index to be a dead-even 50.0. A score above 50 indicates increasing activity; below 50 the opposite.

Stock Markets Equitably Ambivalent

Stocks provided fodder for any scenario anyone might want to construct. For pessimists, there's the fact that all sectors but U.S. small-caps were down. Only the Dow Jones Industrial Average eked out a gain among large caps, a paltry 0.3%. The S&P 500 dropped 0.8%.

Mid-caps were punished according to their "growthiness": The Russell MidCap Growth Index was trimmed by 3.8%, whereas the MidCap Value lost less than a third as much (1.1%).

For optimists, small-caps—presumably the most future-oriented of stock classes—performed handsomely, and also in inverse relationship to

their orientation toward growth. The Russell 2000 Value Index led all equity benchmarks in July with a 5.1% gain. The Russell Growth Index returned 2.3%; the composite of the two—the Russell 2000 Index—was up 3.7%.

International stock indices fairly took a beating in July, all finishing with losses, and all now down in \$US terms for the trailing 12 months. The Pacific Rim Ex-Japan fared worst in July, dropping 5.0%; the EAFE Index fared best, falling 3.2%.

REITs bounced back in July, led by a smart 3.5% gain by the NAREIT (All Equity REITs) Index.

Bonds Mixed (Again), With Reason


Bonds also performed ambivalently, with an evident preference for higher quality. The Lehman Aggregate Bond Index dropped 0.1%, vs. a 0.4% gain for the Lehman Government Bond Index. The Citigroup High Yield Index fell 1.8%, the deepest loss among fixed income benchmarks.

World bond indices all gained at least slightly, led by the JPM Emerging Market Bond Index, with a 1.6% rise. The hedged version of the Citigroup World Government Bond Index Non-U.S. uncharacteristically out-performed its unhedged twin, 1.4% to 0.2%. The unhedged version leads 15.1% to 4.5% for the trailing 12 months.

Commodities Clipped; Hedge Funds Hammered

In keeping with oil prices, the Goldman Sachs Commodities index dropped 12.2%; the DJ-AIG Commodity Index fell 11.9%.

Hedge Fund Research's indices were all down in July, save Merger Arbitrage, which had a return of 0.7%. The Equity Hedge Index fared worst among the six indices, dropping 2.9%. The Fund-of-Funds Index fell 2.5%; Convertible Arbitrage was down 2.1%.



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