

September 23, 2009 – What is Fueling the Stock Market Rally?

Six months ago, it was looking as if the financial world as we all know it was coming to an end. The DOW was at 6500 and most likely would have been around 4000 had world governments not acted. Today the DOW is 9770. Still far below the highs of 14,000 but financial Armageddon has been taken off the table. Some investors are having difficulty understanding how the stock market can rally so strongly while the economy is in such lousy shape.

The answer is simple: liquidity (money). This six month bull market rally has been driven by a coordinated effort of the governments and central banks around the world to flood the system with liquidity. It has not been driven by a historic economic comeback. To prevent a financial meltdown, 33 central banks around the world pumped the equivalent of trillions of dollars into their economies. Governments are on a spending spree not seen in the history of the world and the Federal Reserve is making money easily available to big banks at virtually no cost. This is enough to drive a very strong uptrend in the stock market, at least for the time being.

Eventually the economy must improve enough to stop job losses and actually start creating jobs again. Jobs are critical to an economic recovery because our country is so dependent on the consumer and if people are not working, they are not spending and consumer spending is 70% of the U.S. economy.

While it is true the financial crises that drove the stock market down 57% is basically over, and the worst case scenario has been averted, now we have to deal with pulling back the excess liquidity and the deficit caused by the stimulus spending. Pulling this money out of the system is no simple task. If the Fed leaves the liquidity in the system too long we have the threat of high inflation. For those of you around in the late 70's, you will remember this was a difficult time. But on the flip-side, if they pull the liquidity out too soon the economy could collapse. A bit like threading a needle with a front loader.

The other major issue is the exploding federal debt created by passing out trillions of dollars in government stimulus money. Couple this with the soaring liabilities from social programs and corporations and the wealthy will carry the burden of paying for this debt, which seems to have grown in size to a point of no return. To pay for this, some say the marginal tax rate is clearly moving towards 60% and sooner rather than later. Both of these developments will likely be an enormous headwind for economic prosperity and hence the stock market in the years to come.

For now, everything is coming up roses. Fed Chief, Ben Bernanke, is saying the recession is over, the government is spending like a drunken sailor, and stocks are in an uptrend. My concern now is we get a stock market melt-up. Many institutional money managers had bad returns in 2008 and moved to cash at the bottom and are underperforming again in 2009. Now they are worried about being fired so they have to chase performance in an attempt to eke out some nice gains for 2009.

If the market melts up another 10-20% in the near-term then I fear we are setting up for another crash near the end of this year or in 2010. So enjoy it while it lasts but don't fall into the trap of disregarding risk. Have an exit plan in place that will get you out if the market crashes again as risk management is as important now as ever. I view this recent rally as a gift to those who held through the crash to get out at a higher level. Many of you are at a point in life where it is difficult to make up losses so don't let this rally pass you by. The bear markets of 2000-2002 & 2007-2008 were not random events.

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