Philequity Corner (September 7, 2009)
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September to Remember

September 2008 was the month that made the world tremble. It was the month when Fannie Mae and Freddie Mac were taken over by the Federal government, Merrill Lynch was sold to Bank of America in a shotgun deal, AIG was bailed out, Washington Mutual was seized by the FDIC. The culmination was the collapse of Lehman Brothers. Around the world, other banks were nationalized, stock markets plunged, and millions of jobs were lost during the aftermath as the world economy suffered its worst downturn since The Great Depression.

With all the chaos and confusion still fresh in investors' mind, many are feeling the jitters as the first year anniversary of the fall of Lehman Brothers approaches.

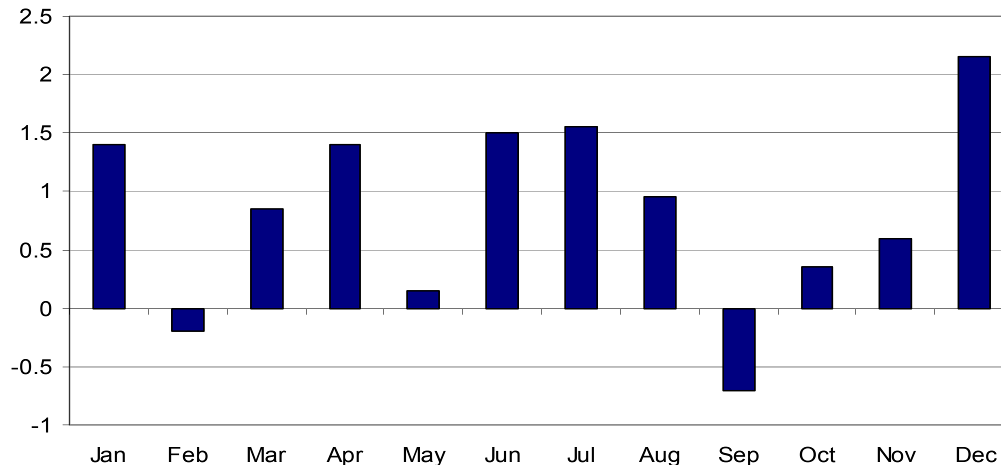
Starting on the wrong foot

Last week, the US markets declined sharply at the start of the week shortly after reaching year-highs the prior week. The S&P 500 index which hit 1,039.47 last August 28 fell as much 4.6 percent to an intra-day low of 991.97 on September 2. This drastic move down has prompted calls by experts, brokers and fund managers for a steep correction.

Fear of September

Investors worry a lot during this time of the year not only because of what happened in 2008 but because September has historically been the worst month of the year. In fact, the average return for the S&P 500 index during the month of September is -0.7 percent. Coupled with the fact that the memorable crashes of 1929, 1966, 1973, 1987, 1989 and 2008 started in September and culminated in October, investors indeed are stricken with fear whenever the so-called "BER" months arrive.

S&P 500 Index Average Monthly Return in % (1928 to present)



Source: Bloomberg, Philequity Research

Experts call for a correction

In addition to the September fear, stock market experts are turning more cautious because of the following reasons:

1) THE FEAR OF CHINA. China's CSI 300 index has dropped as much as 25 percent since the start of August. As discussed in *The China Syndrome* (see August 24, 2009 issue of **The Philippine Star**), investors fear that since China led the world out of the economic

downturn, it may lead us back into the bear market. However, it was interesting to note that while the Chinese stock market more than doubled from October 2008 to August 2009, it has not experienced any sharp pullback since February 2009. Therefore, the correction since August is not only viewed as normal, but in fact, healthier for Chinese stocks.

2) THE MARKETS ARE OVERBOUGHT. Most technical analysts say that the equities markets are overbought and due for a pullback. The 14-day RSI (which measures relative strength), for example, indicates that the S&P 500 index is overbought since August. That was the first time the market registered such conditions since reaching oversold levels back in March.

3) TOO FAST, TOO SOON. Most investors feel that stocks have moved up too fast and too soon. While most major averages are still down from their year-ago levels, they have risen quite sharply from their lows registered in March.

The S&P 500 index, for example, is now up 53 percent from its low of 666 in just six months – one of the largest percentage increases over this period of time in its history.

In the case of the PSE Index, it is up 51 percent year-to-date and 68 percent since the bottom in October 2008.

4) THE MARKET IS GETTING PRICEY. The S&P 500 P/E ratio is now at its highest level since the end of 2004 according to Bespoke Investment Group. The valuation has almost doubled from a low of 10x 2009 earnings at the start of the year to 18.4x as of end-August. This is what happens when the S&P 500 rallies 50 percent (the P) and earnings (E) continue to decline. As of 2Q09, the S&P 500 has recorded eight straight quarters of negative growth.

In contrast to US earnings, corporate earnings in the Philippines is expected to grow 10 percent this year. At current prices, the PSEi trades at 15x P/E 2009.

5) RISK OF A DOUBLE-DIP (W-SHAPED) RECESSION. While there are some signs that the US economy is slowly gaining traction, many analysts note that a soft job market and increasing home mortgages "underwater" raises the possibility of a double-dip recession. With $3.4 trillion worth of home mortgages underwater, banks are less likely to help fund home purchases for risky borrowers. Rising unemployment and foreclosures may push prices even lower, further impacting the economy and feeding a vicious spiral that could hurl the economy back into recession.

Consensus is always wrong

Most analysts were expecting a sharp sell-off in the equities markets last week after falling hard last Monday. But by the end of the week, the markets have recovered with the S&P 500 index pushing back above 1,000 to close at 1,016.50 by Friday. This always happens during bull markets. When everybody thinks the markets will come down, things easily change and they usually return back to their primary trend.

As we have said before, corrections are hard to predict. Often, the markets do exactly the opposite of what most investors expect. So many times since stocks bottomed in March buyers have come in after some sort of pullback when most market watchers were expecting prices to fall some more.

With regard to China, it has already corrected 25 percent from the peak and we believe that other markets have already priced-in this sizeable correction.

With regard to moving too fast and too soon, one must remember that the S&P 500 index is still off by 35 percent from its peak of 1,565 in 2007. In the case of the PSE Index, it is still off by 27 percent from its peak of 3,896 in 2007.

With regard to fundamentals, the stock market is always forward-looking. So while earnings for 2009 are bad in the US, the market may be pricing a significant earnings recovery in 2010. Meanwhile, the PSE Index at 15x 2009 earnings is the 4th least expensive market in Asia.

Sharp sell-offs are buying opportunities

Reiterating what we have written in previous articles, corrections or pullbacks may come and go. However, nobody knows when they will come, how deep they will be and how long they will take. What is important is that the long-term trend is already up. In fact the sharp sell-off last week was a good buying opportunity in anticipation of healthy returns coming from the customary Santa Claus rally in December and the January effect.

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