Philequity Corner (March 29, 2010)
By Valentino Sy

Goldilocks and the Three Bears

When investors talk about the stock market, they usually associate it with the two beasts of finance, the bull and the bear. We all know that these creatures are used to characterize the direction that the market tracks over time. The market is said to be bullish when it is trending upwards, and bearish when it is trending downwards.

A bull market is also associated with rising investor confidence and increasing expectations of higher stock prices as a result of an economic recovery or an economic boom. On the other hand, a bear market is characterized by widespread investor fear and pessimism and continuously falling stock prices as a consequence of a weak and deteriorating economy.

Animals Galore

During the bear market, we wrote about bear watching (see *Bear Watching*, July 21, 2008) to help our readers look for signs of a potential turn in the market.

Last year, we wrote about the reluctant bull (see *Back With a Vengeance*, October 19, 2009), saying that despite the huge rally in the markets, many investors are still reluctant to join because they have focused too much on the pain of the recent crash and not on the recovery.

Lately, however, we have used other members of the animal kingdom to illustrate our thesis. Last week, ARSamson talked about ducks, referring to how outgoing governments feel during election periods (see *Bulls, Bears and Sitting Ducks*, March 22, 2010).

We even discussed insects, particularly the "ipis" (see *IPIS Theory*, February 22, 2010), where we assessed the consequences of a sovereign debt problem contagion in Europe.

Prior to that, we wrote about the tiger (see *Eye of the Tiger*, February 15, 2010), referring to the stock market's performance during Tiger years in the Chinese calendar.

Also, we previously discussed "PIGS" (see *PIGS Get Slaughtered*, February 8, 2010) where we warned that problems in countries like Portugal, Italy, Ireland, Greece and Spain may cause a deep correction or stall the advance in asset prices. We also talked about "STUPID PIGS" (see *One Year After*, March 8, 2010) which included other highly indebted countries such as Turkey, Ukraine, UK and Dubai.

Not too hot, not too cold

In the long run, what we are wishing to achieve is an economy that is not too hot, not too cold or the "goldilocks" scenario.

In children's fairytale, a little girl named Goldilocks went wandering in the forest where she soon came upon a house owned by three bears. Inside the house, she found three bowls of porridge. Since she was hungry, she tasted the first bowl (belonging to Papa bear) which was too hot. She tasted the second bowl (belonging to Mama bear) which was too cold. Then she tasted the last bowl (belonging to Baby bear) which was just right, and she happily ate it all up.

Sweet spot

In economics, the "sweet spot" is what Goldilocks likes, an economy which is not too hot, not too cold.

Papa bear's porridge (which was too hot) refers to an economy which is overheating. Too much monetary easing for too long can cause high inflation which is bad for the economy in the long run.

Mama bear's porridge (which was too cold) refers to an economy unable to sustain its recovery. Too little stimulus or a premature removal of stimulus can put the economy back in recession.

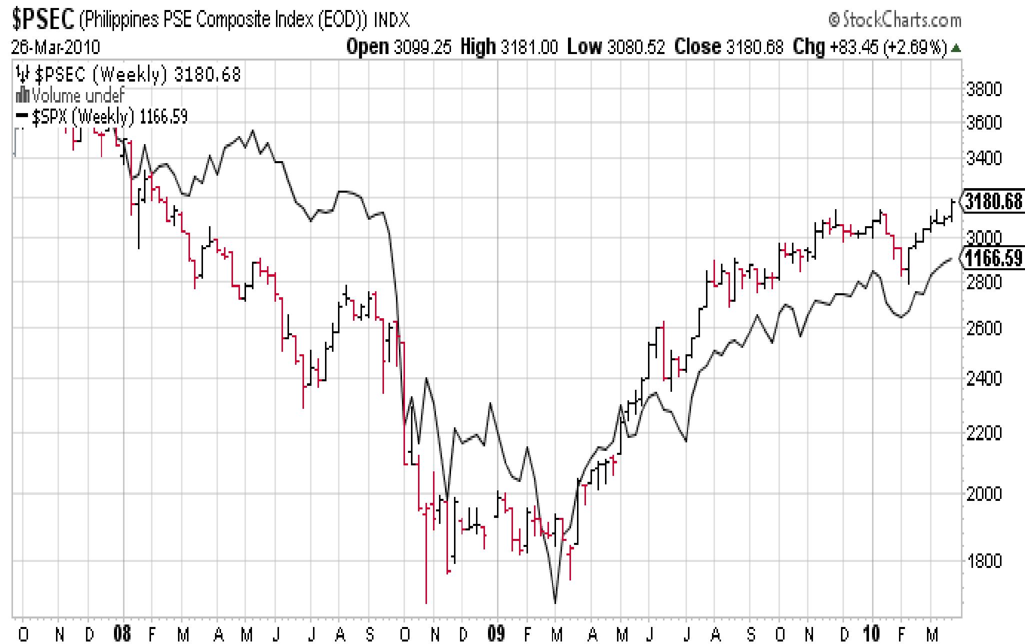
Meanwhile, Baby bear's porridge (which tasted just right) refers to this economic "sweet spot" where inflation is tame and interest rates are benign, allowing for a moderately strong economic growth.

Goldilocks = Rising asset prices

Bernanke and the Fed are bent on keeping the economy on this sweet spot, a.k.a. the goldilocks economy. Despite evidence of an accelerating global economic recovery, they have pledged to keep the record-low interest rates for much longer, adding up to ever more generous liquidity conditions.

As a result, we continue to experience one of the most powerful stock market rallies in recent history. As of last week, the S&P 500 index closed at 1,169.59, the highest weekly close since September 19, 2008. It is now up 76 percent from its March 6, 2009 low of 666.

Meanwhile, our own PSE index closed at 3,180.68 for the week, the highest since February 16, 2008. It is now up 89 percent from its October 28, 2008 low of 1,684.75.



Risks to our goldilocks scenario

There are several risks to our goldilocks scenario and these are the following:

1) Premature removal of the accommodative policies.

2) Interventionist policies by the government that will curtail the free-market system.

3) Sovereign debt problem contagion that spreads throughout Europe and other parts of the world.

4) Steep rise in asset prices, particularly commodity prices like energy, grains, etc.

If the stimulus programs are removed prematurely or the government becomes interventionist or if there is a debt problem contagion, then the risk is that the economy goes back to recession. On the other hand, if prices of assets (like commodities, real estate, stocks, etc) go up in a spiral, then the risk is that inflation becomes uncontrolled and the economy overheats.

When will the bears be back?

Just like during our bear watching, we now have to monitor the US closely for signs that point to a bull market that is ageing. Watch out for inflation data that may show that the economy is overheating. Carefully track the index of leading economic indicators (LEI) and other macroeconomic data that may show that the economy is going back to recession.

In the meantime, continue to ride the bull market, because we are at the sweet spot. Partake of the porridge of baby bear that is just right - thru investments in stocks, mutual funds and other assets that thrive in the goldilocks environment.

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