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Bill Gross Shoots, But Can't Hit

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Donald Luskin

If this is a real "liquidity crisis," then the Dow is at 5000.

According to Bill Gross's monthly report published yesterday, there is "sudden liquidity crisis in the high yield debt market." How much of a "crisis" do we really have when the Merrill Lynch High-Yield Index spread is only 3.6%? That's well off the lows to be sure, but it's still well below the long-term average of 5.0%. This is the "crisis" of a market that briefly got a taste of extraordinarily generous credit conditions, and is now having to settle for only *very* generous. But for Gross, this is a market that "resembles a constipated owl" (a reference to the old joke about a drunken marksman who can shoot, but can't hit).

We don't agree. We don't doubt that there's something of a buyer's strike going on, and that it will take some hard bargaining to get some of the LBOs in the pipeline done. But with the dollar making new lows, and with gold and other monetary commodities at or near new highs -- and with Fed rate cut expectations coming back into the fixed income futures markets -- liquidity would seem to be quite abundant, indeed *over-abundant*. In this environment, a liquidity crisis of any important magnitude or duration is quite unlikely. A normalization of spreads? A renegotiation of the price of risk between issuers and buyers? Sure, and maybe even some overshoot in the correction process. But not a "liquidity crisis."

Update to strategic view
US STOCKS: Stocks are in a consolidation, hostage to the adjustment taking place in the credit markets. We think that credit markets will quickly right themselves, and we will be looking for an entry point for stocks. The catalyst for recovery will probably be the successful completion of one of the several LBOs now thought to be imperiled, demonstrating both the value case for stocks and the resiliency of the high-yield debt market.
[see Investment Strategy Dashboard]

The S&P 500 fell 2% yesterday, with Gross prophesying that "No longer...will stocks be supported so effortlessly by the double-barreled impact of LBOs and company buybacks." But here, too, we hardly have a "crisis" on our hands. The CBOE Volatility Index (VIX) stands at 18.5, below its long-term average of 20.8. And Gross is wrong to argue that LBOs and buybacks are supporting stocks. *Value in relation to earnings* is supporting stocks, and *that's* what's been motivating LBOs and buybacks (see "The King Is Dead, Long Live the King" July 9, 2007).

Since Gross disastrously predicted "Dow 5000" on September 3, 2002, S&P 500 consensus forward earnings have grown by 77%, yet market capitalization has grown by only 64%. That is, the forward price/earnings ratio of the S&P 500 is lower today than it was then -- making stocks

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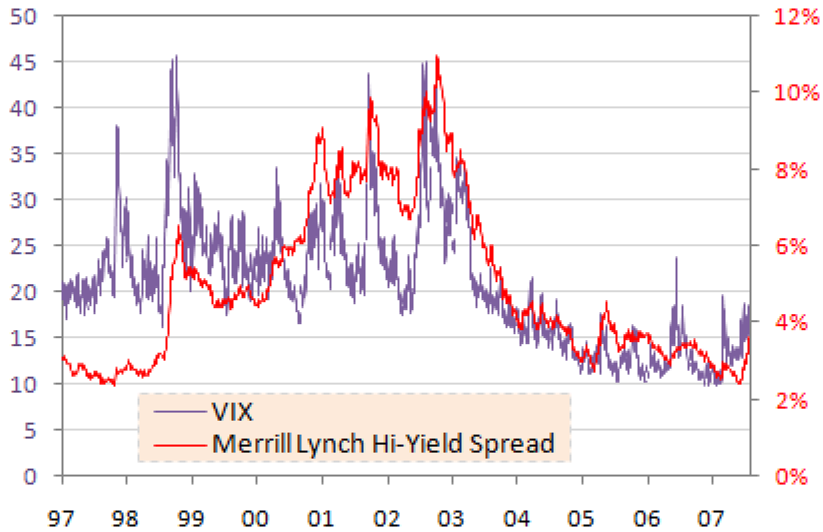

"Liquidity crisis" -- or just a (partial) return to normalcy?

a better bargain today than they were six weeks before the very bottom of the 2000-2002 bear market. Moreover, then forward earnings estimates were still falling. Today they are rising. Despite the pervasive impression that the current earnings season has somehow been a disappointment, the reality is that the S&P 500 consensus growth forecast is 14.1%, and month-over-month forecast revisions are running at a 15.4% annualized rate (the fastest clip in over a year).

How long will it take the present episode of fear to burn itself out? In 2002, during another episode of fear, it took six weeks from Gross's "Dow 5000" report. On the day that report was released, stocks fell 4.2%, the worst single day in that difficult year. Six weeks later, stocks had fallen 15.8% -- a decent down-payment on the 42.3% decline predicted in "Dow 5000." But just a month after that, all the losses had been recouped. Gross had written, "stocks stink and will continue to do so... bonds will be the best performing asset class for years to come." Since then, through yesterday's close, the total return of the S&P 500 has been 80.0%, while 10-year Treasuries have returned only 15.7%. While recognizing that Gross can move the market in the short term, strategically we have to regard him as a contrary indicator. The overheated pessimism of his report yesterday is an encouraging sentiment reading that complements our fundamental assessment that liquidity remains plentiful and that stocks remain attractive.

BOTTOM LINE: Stocks are in a consolidation, hostage to the adjustment taking place in the credit markets. We think that credit markets will quickly right themselves, and we will be looking for an entry point for stocks. The catalyst for recovery will probably be the successful completion of one of the several LBOs now thought to be imperiled, demonstrating both the value case for stocks and the resiliency of the high-yield debt market.