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On the Dubai Debt Crisis

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At last, an event catalyst for a long-overdue correction in stocks.

Update to strategic view
US STOCKS: The Dubai debt shock is hopefully the catalyst for a correction that was destined to come anyway. Our premise going in is that this will be only a healthy correction, not a revisiting of the March lows. **GOLD:** Gold is getting hit as deflation fears re-emerge in the wake of the Dubai debt shock. But this will only dig the Fed in deeper on its inflationary policy course, making this a very buyable dip.
[see Investment Strategy Dashboard]

The news that Dubai World will seek to restructure some of its debt has been in markets since Wednesday -- after a day's lag, markets have seized on it as what we hope we be a catalyst for a much-needed correction in stocks. What may be particularly salient about this threat is that Dubai World is a state-sponsored firm, and this default casts doubt on what has been the bottomless ability and willingness of governments to support systemically important enterprises. But if it hadn't been this, it would have been something else. Stocks and other risk-assets have come too far, too fast, and credit markets have become complacent. Until we know more, we're going to assume that this is just the healthy correction we've hoped for -- and a buying opportunity.

Clues pointing to an impending correction have been accumulating. The rally in stocks from the March bottom has been matched in only two extraordinary historical cases -- at the onsets of the 1915-1918 and 1933-1937 expansions, in both of which corporate earnings nearly tripled (see "Triple Play? No Way!" November 3, 2009). The financial sector, the miraculous recovery of which led the stock market's run, topped out in mid-October, and as of Wednesday's close was off 6.8% even as stocks overall made new recovery highs (see "Easing -- As in Appeasing" November 23, 2009). And when seen priced in appreciating gold rather than in depreciating dollars, actually topped in late August and indeed are now off 15.4% since then -- implying that apparent new recovery highs say little about growth prospects, and much about excessive liquidity (again, see "Triple Play? No Way!").

BOTTOM LINE: The Dubai debt shock is hopefully the catalyst for a correction that was destined to come anyway. Financial stocks, which led the rally from the March lows but topped out in mid-October, should get the worst of it. Our premise going in is that this will be only a healthy correction, not a revisiting of the March lows. Gold is getting hit as deflation fears re-emerge in the wake of the Dubai debt shock. But this will only dig the Fed in deeper on its inflationary policy course, making this a very buyable dip.

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