

Q1 2009 Market Commentary



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Putting in the Bottom

As painful as the first quarter was, we are observing a growing number of signs of a bottoming process in the economy in general and the stock market in particular. This not to say we are coming out of the recession right now but rather that economic activity has stopped its precipitous decline and the system is beginning to stabilize itself. And equity markets are simply coming back from an overly pessimistic view that was brought on by Lehman's failure last September and the overnight drying up of credit. There are signs everywhere that credit is beginning to flow again, in bond and equity markets, the mortgage market and international trade. The grease is re-emerging.

Lets take a quick look at the U.S. housing market. Housing prices appear to be declining as fast as ever with the S & P's Case-Shiller house price index declining 2.8% in January in all 20 cities surveyed. While many may see this as a bearish sign, we believe that the fall in housing prices may be nearing the end. Housing affordability is now at its highest reading since 1971 and lower prices will simply help the housing market to clear that much sooner. The U.S Federal Reserve has gone to great lengths to support the housing market and the rate for 30 year fixed-rate mortgages in the U.S. dropped below 5% for only the second time in history. We suspect that when potential home buyers recognize that prices aren't going down further and may in fact turn up, they may step into the market in a hurry.

On a different subject, China's economy is showing numerous signs of stabilizing and perhaps turning back up. The Chinese authorities were the first to recognize the severity of the problems back last fall and announced a massive stimulus package very quickly. As a centrally planned economy, one aspect that we have long admired of the Chinese is that they can get things done in a rapid fashion. Chinese money supply growth (M2) has exploded (See Chart One), and Chinese banks are lending vigorously.

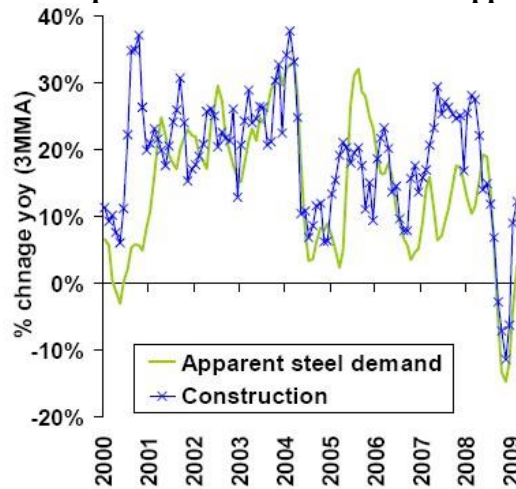
Chart One: Chinese Money Supply Growth (M2)



Source: China Metals, Macquarie Research, March 2009

In particular, China's real estate sector appears to be on the cusp of a recovery (See Chart Two), and demand for construction steel, copper etc. is rebounding.

Chart Two: Chinese floor space under construction and apparent steel demand up



Source: China Metals, Macquarie Research, March 2009

No doubt, on the way back up, some producers may overshoot (e.g. Chinese steel production may be ahead of itself in the short term), but the trend is definitely improving. China's PMI has been steadily increasing since its low in November at 40.9. The government's official tally for the PMI now stands at 52.4 which indicates a growing economy (i.e. a PMI over 50 is considered expansionary). While we have reservations that this number will not hold over the next two months because of seasonality, the trend is definitely in the right direction.

As a final example of the direction in the Chinese economy, we include Chart Three from UBS securities, which we think exemplifies the current trends in China.



Source: CEIC, UBS Estimates

From the economists at UBS, "More than exports, more than fiscal stimulus or anything else in the economy, China's property and construction downturn has been the most crucial macro trend of the past year and the future of construction demand is the most important swing variable in determining China's fate in 2009 and beyond. Despite a large inventory overhang and post-bubble de-leveraging pressures in the luxury end of the housing market, on an aggregate nationwide basis China's neither significantly overbuilt, over priced, nor over levered and the mainland can and should see a construction recovery this year."

To wit, Chart Four, which shows the share price performance of China Resources Land, a manager and developer of residential properties in mainland China.

Chart Four: China Resource Land (1109 HK)

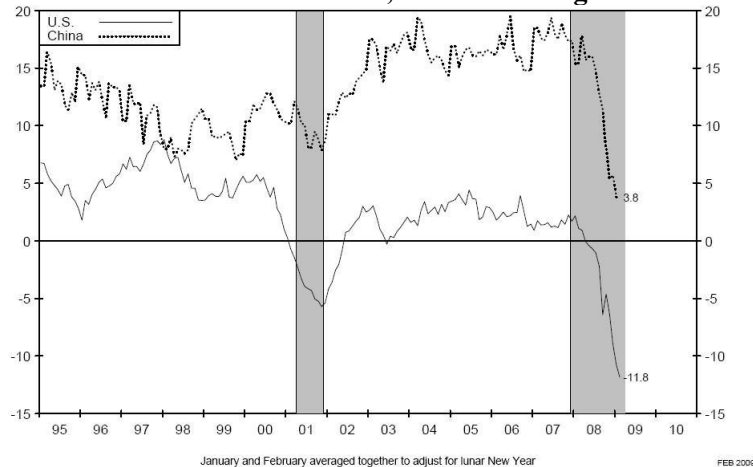


Source: Bloomberg

We would not suggest for one second that China’s economy can save the world, it can only save itself. But in doing so, we believe that China’s economic performance can underpin a host of commodities and lead to further confidence in the global economy.

So where does all this leave us? The consensus view is that an economic recovery will take a very long time, two, maybe four years. With our contrarian view at Galileo, we suspect that once again the consensus will be wrong. We may emerge from this downturn more quickly than the pundits think due to the massive inventory correction suggested by Chart Five . Many industries will realize that the cupboard is bare and the need to ramp up production (basic materials comes to mind here).

Chart Five: Industrial Production , Percent Change Year-Over-Year



Source: TD Securities

Without question, there is much more negative news to come but do not be fooled by the headlines. Much of it is rearward in nature. We fully expect the stock market to suffer retreats on the road to recovery and these events will test our conviction. But in our view, we have passed the worst and a new inflection point has emerged.

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