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## *Where Demand Meets Supply*

One year ago today, we advised our readers to resist "the pressure to get back in" that was coming from the media's coverage of what was thought to be an economic recovery. "In a situation like this, ask yourself who is more worthy of your trust: the media or the markets? The former gives you hype and hysteria; the latter delivers efficient pricing of all known information. In spite of the good economic news, the markets have been flat… Our guess is that there will come a time, possibly later this year, when we see the reverse: the media will become increasingly pessimistic while the markets rise in the face of bad news. That will be the time to buy." ("Decision Time," *fcNOTES*, March 31, 2002)

Readers who avoided stocks one year ago in spite of the apparent good news in the economic data were well served – from March 31 to July 31, when we recommended that investors allocate one-third of investment cash reserves to stocks, the S&P 500 plunged nearly 21%. On October 31, we increased our recommended equity allocation to 60%. Using the S&P 500 as our proxy, and assuming that any interest paid on the remaining cash reserves was offset by transaction costs, those who have followed our advice have seen their portfolios decline 3.44%.

Not bad, considering that the S&P 500 has lost more than 26% in the past 12 months, but doesn't it *feel* worse? Given how much more frightening the news is today than it was last fall, shouldn't the stock market be *much* lower than where it was in July and October of last year?

Of course not. As we often point out, the market always moves well in advance of major changes in the underlying economic fundamentals, which is why it is so important to recognize divergences between what the media is reporting and what the market is actually doing.

### Who Is Right?

Today's media coverage of the economy reveals a rapidly growing consensus that prospects for recovery after the conflict ends are not good. The optimism of Wall Street economists – so prevalent at the start of 2001 and 2002, when all the talk was about the certainty of a "second half recovery" – has given way to speculation that even a decisive U.S. victory in Iraq will not do much to solve the many problems that plague our economy.

A perusal of *The Wall Street Journal*, a publication that is for the most part optimistic about the war, demonstrates the extent to which conventional wisdom has soured when it comes to the economy and the markets. Just one day after stocks exploded higher by more than 3% on March 13, *The Wall Street Journal* reported that economists were slashing their estimates of economic growth for the first half of this year: "The glum mood contrasts with the start of the year, when many forecast rising business investment would lead to a pickup in growth that would accelerate as the year progressed." And in a March 22 article titled "War Rally Could Plateau Without Retail Investors," *The Wall Street Journal* online edition warns that, "Strategists on Wall Street are convinced that the brunt of the investing public still doesn't have the stomach for stocks, and that could keep the brakes on any war-inspired rally… Recent stock gains–largely fueled by short-covering at this point, according to traders–could also come to a quick halt depending on the economic climate in the U.S. at the end of the war."

But the market is telling us something different. Unlike last March, when all signs pointed to economic recovery but stocks were basically flat for the year, today all indications are that economic and geopolitical risks are rising – and the market is essentially flat (the S&P 500 finished the quarter down 3.6%, but the Nasdaq actually closed higher by 0.42%). Just as the market then was telling investors to take a second look at what appeared to be good news, the market today is sending a message that perhaps the future isn't as bleak as it appears on the evening news.

### Economics 101

We have predicted that 2003 will be one of the best years ever for stocks, and to those who wonder how that is possible given so many obvious problems on the economic landscape, not to mention the

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many uncertainties of war, we want to share a secret:  Stock prices are determined by supply and demand, and the factors impacting supply and demand are not always what they seem to the naked eye.

The price of *any* category of financial asset is a function of how many people want to own it relative to how much of it there is.  During periods of optimism for a given asset, rising demand leads to rising prices, which in turn generate the incentive for producers to create more of it – just as oil drillers will boost exploration budgets when oil prices increase and homebuilders will build more homes when the housing market is expanding, entrepreneurs, venture capitalists, and investment bankers will create more stocks (via initial public offerings or spin-offs) to cash in on a rising stock market.

During the late 1990s, demand for technology and telecommunications stocks, especially those related to the Internet, far outstripped the available supply.  In August of 1995, Netscape more than doubled in price on its first day of trading because there were few stocks that one could buy at the time to get in on the very real growth potential of the Internet.  Indeed, prior to Netscape, there was no Internet sector per se.  Contrary to the popular notion today, there was nothing "irrational" about the run-up in stocks like Netscape; with all the world's investors wanting to buy into the exciting new technology, and with few stocks available to do so, the surge in tech and telecom valuations was the result of the most rational of economic principles – when demand rises in a low-supply environment, prices go up.

It was equally rational that venture capitalists and investment bankers in the late '90s would rush to create more Internet companies to meet this demand, while several "old economy" companies like the bookseller Borders would spin off their online divisions as separate stocks.

**There's Always a Bull Market Somewhere (So Look Out Below)**

Hard as this may be to accept, there is really no difference between today's most popular asset categories and the tech stocks of yesteryear when it comes to how supply and demand impacts prices.  Whenever prices rise in a relatively free market, so too does the incentive to figure out some way to produce more.  And at some point, supply outstrips demand and prices turn lower.  Sometimes sharply lower.

Those fleeing stocks right now for the "safety" of bonds, gold, and real estate would do well to remember the lessons of economics 101.  With an expensive war being waged in Iraq and a tax cut in the works, not to mention state and local governments suffering from huge budget deficits, the incentive for government agencies to create more *bonds* and take advantage of the record-high prices (the corollary of record-low rates) seems obvious to us, though apparently not to the countless investors who are dumping equity fund investments and pouring record amounts into bond funds.  And we can assure you that gold mines are humming in anticipation of rising profits ahead – they can't get the yellow metal out of the ground fast enough to meet the growing demand for this ancient metal of kings.  As for real estate, homebuilders are showing no signs of slowing down and are expected to post double-digit earnings for the first quarter of 2003.  With mortgage rates so low and prospects for stocks so uncertain, the stagnant economy has so far done little to keep homebuyers away, and to date there has been no direct pullback in demand for housing as a result of the war.

When prices of today's hot investments begin to fall, the reason will not be obvious changes in the economy; the reason will be a subtle yet sustained shift in the equilibrium between supply and demand.  It will start slowly, as bear markets always do, because demand does not disappear overnight and producers never recognize the early signs of a slowdown.  Only in hindsight will those who suffer from falling prices be able to point to the "reasons" for the decline and wonder why they didn't see them sooner.

**Stock Up**

Demand for stocks today is a mere shadow of what it was just a couple years ago – as we observed last month, investors pulled half a billion dollars out of U.S. equity funds in January, the seventh outflow in eight months and the first January withdrawal since 1990.

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But while falling demand for stocks has been widely reported, few have given much thought to the fact that the *supply* of stocks has also declined. Many companies have simply gone out of business, while others have been acquired by competitors or folded back into the parent companies that spun them off as "dotcom" businesses.

At the same time, there is little in the way of new supply coming onto the market. Very low demand for stocks has nearly eliminated the incentive to produce more – when was the last time you heard about a hot IPO? Last year saw the smallest number of initial public offerings since 1991, and this year began with the first IPO-free January in America since the 1974 bear market. New issues in the past twelve months as a percentage of all stocks traded on the New York Stock Exchange have fallen to a mere 3%. Contrast that with April 12, 2000; the market had peaked and the bear market had begun, but the producers of stocks didn't know it yet. On that day, new issues over the previous year reached a staggering 22.3% of NYSE stocks.

The relationship between supply and demand in the stock market today is nearly the opposite of what it was in early 2000, a year that will go down in history as one of the most dangerous times to be in the market. Seen in this context, will it really be all that surprising if 2003 is remembered as one of the best years to buy stocks? We don't think so.

**What Demand?**

While the shrinking supply of stocks sets the stage for an increase in prices, it cannot drive a sustained recovery by itself. After all, even if supply is falling, if demand is falling faster, prices will continue to move lower. With the average investor becoming more pessimistic by the day, it is hard to see how demand for stocks can pick up in the near future. But it already is, if you know where to look. Three important sources of demand for stocks that are being overlooked by the media today are corporate insiders, underfunded pension plans, and short sellers.

***Corporate executives and directors*** are highly opportunistic investors and are usually among the first to recognize supply and demand imbalances in their own stocks. Last August, we observed that insiders were quietly accumulating shares in spite of falling prices, in stark contrast to the high sell-buy ratios seen in the first half of 2002, *before* the market pushed down to new lows after the failure of the post-9/11 rally.

In spite of enormous market volatility since last summer, the longer-term insider trading ratios have remained largely in bullish territory, and the volume of insider buying has recently picked up again. It seems that serious international and economic turmoil has not been enough to shake the high degree of confidence that these insiders have in the shares of their own companies. While research has shown that significant changes in insider trading patterns can occur well before a change is seen in the overall direction of stocks, there is nonetheless a very strong historical correlation between high levels of insider trading activity and stock prices over the following twelve months. Indeed, significant insider trading has an almost uncanny record of accurately forecasting market moves of 30% or more.

***Pension funds*** have been an area of concern lately, given the huge losses they have suffered on stock holdings during the past three years. The conventional wisdom is that pension plan shortfalls will be bad for the market, since companies will have to redirect huge amounts of money away from areas that would benefit investors (research and development, capital equipment, dividends, etc.) to meet their obligations to retirees. This is true, but as is usually the case, the media fails to recognize the *positive* impact that this will have on demand for stocks; the additional money pumped into pension plans will be invested, and the asset allocation discipline of fund managers means that most of it will be used to buy equities. In his March 31 column for *Forbes* magazine, money manager Ken Fisher estimates that pension funding in the U.S. and abroad will generate about $40 billion in additional demand for stocks in 2003, while another $30 billion will come from public retirement systems.

***Short sellers*** are an early source of demand for stocks in a depressed market, though rarely are they thought of in this context. Because short sellers profit when stocks fall, they are often the media's favorite scapegoat in a bear market. But as is the case with underfunded pension plans, the media has it backwards; rather than causing markets to fall, short sellers actually help stocks recover by stepping in to buy shares when no one else will (short-sellers borrow shares of stock and sell them

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with the objective of repurchasing the shares later at a lower price). If stock prices rise, shorts can get "squeezed," a vicious cycle in which short sellers themselves cause prices to rise as they scramble to cover their positions ahead of other shorts.

How does short-selling impact demand? Simple. The very act of shorting a stock creates demand, since short sellers pay interest on the borrowed shares and are therefore eager to buy them back relatively soon. The more shares the short sellers borrow, the more latent demand there is in the market, because all that stock has to be bought back. Looking at short selling from this perspective, demand for stocks has been rising dramatically over the past twelve months, and the short interest ratio on the NYSE (a measure of the number of days it would take short sellers to cover their positions given the market's average trading volume) remains very high in spite of the mid-March rally. This is a lot of fuel for a powerful move higher, and with so much bad news in the market already, it won't take much in the way of positive surprises to spark a fire.

**Don't Bet on a Loser**

There is little doubt in our minds that the bear market that started in early 2000 *ended last year* in October, the same month in which we recommended that investors substantially increase equity allocations. Of course, the media continues to refer to the "bear market" on an almost daily basis, but that should come as no surprise to our readers; as we wrote back in January of 2002, "By the time the media jumps on the bandwagon, the perceived danger is either already on the way out – or it never existed at all."

The trillions of dollars wiped out in the past three years are proof enough that the danger was all too real, but as always, the media was the last to figure this out. At the end of 2000, with the S&P 500 having fallen nearly 14% from its March high, *BusinessWeek* declared with confidence that, "Markets will actually improve in 2001."

Those who bet on *BusinessWeek's* prediction lost badly that year – the S&P 500 fell 13% in 2001.

At the end of 2001, an undaunted and unrepentant *BusinessWeek* observed that, "The battered economy, a brutal bear market, and an unrelenting battle against terrorism have driven investors to the sidelines. That's probably the wrong place to be now." *BusinessWeek* then went on to explain the many reasons why investors should get back into the market in an article titled, "Stocks: Onward – and Mostly Upward."

Those who gave *BusinessWeek* another chance lost again – the S&P 500 plunged 23% in 2002.

As we did one year ago today, we urge our readers to step back and ask themselves who is right – the media or the market? In the March 17 issue of *BusinessWeek*, the editors go so far as to proclaim that, "Given the economic and military uncertainties the U.S. faces, only a fool would be optimistic at this moment." And while the major averages are merely mixed after the first three months of 2003, after losing so much during the past three years, *BusinessWeek* is only now recognizing the danger and advising readers to be cautious; in stark contrast to the bullish recommendations in early 2001 and 2002, the editorial page in the March 10 issue recommends that investors "play defense" by allocating more money to "different kinds of investment vehicles."

A little late for that now, don't you think?

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