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Commentary

Market Opinions and Topics of Interest

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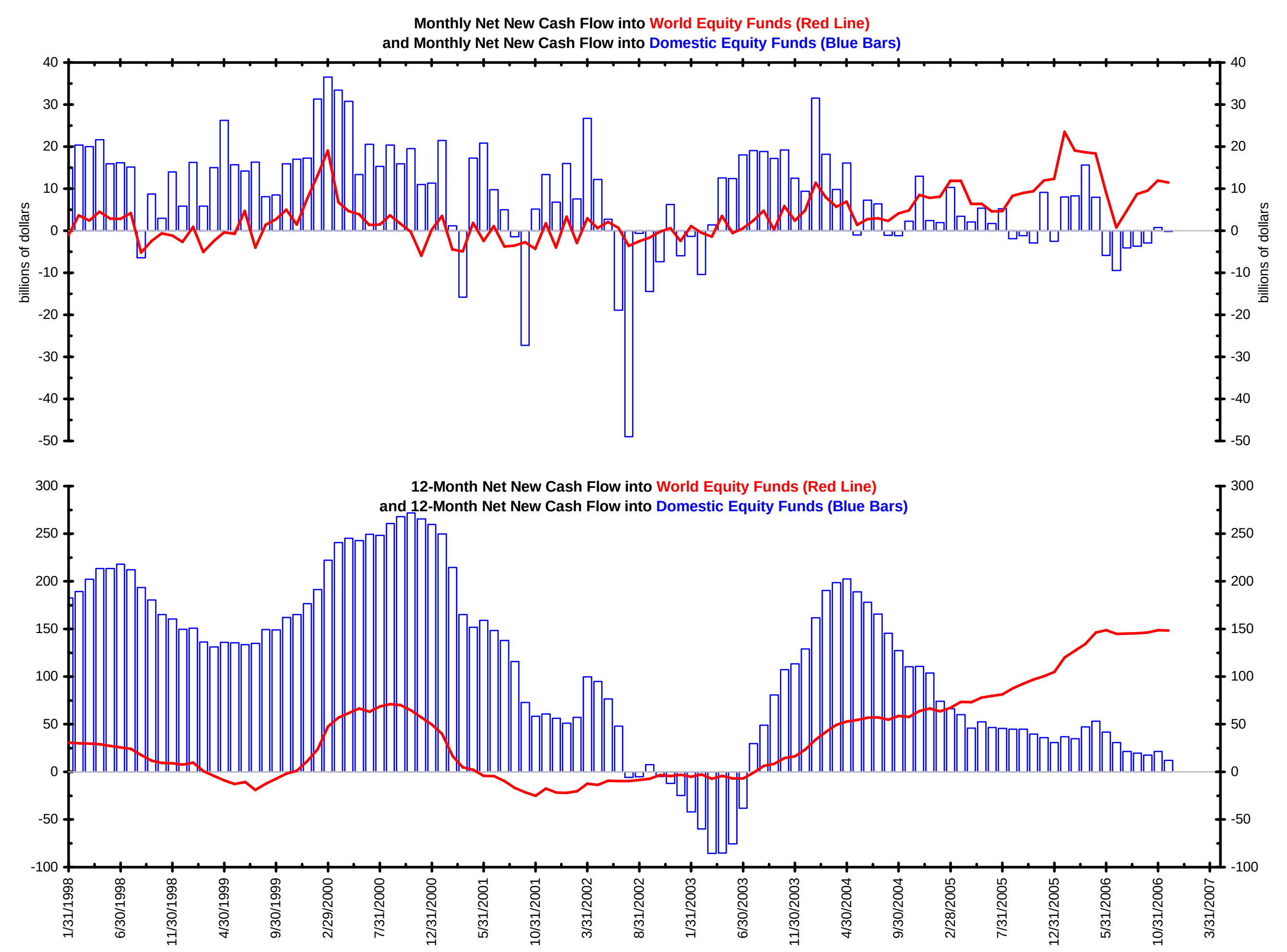
Liquidity In The Stock Market

A funny thing happened on the way to the great liquidity surge in the stock market. The data shows it does not exist.

We can track both the flow of funds into domestic (blue columns) and world (red line) equity-oriented mutual funds. The flows into the world funds clearly dominate on both a monthly and 12-month basis; in fact, since the 7% decline in the S&P 500 in May 2006, domestic mutual funds suffered **outflows** of $25.3 billion (data through November).



Rally Without Inflows

Interestingly enough, equities have been enjoying an extraordinary rally during the latter part of this past year.

Longest Periods Without A 2% Correction
S&P 500 Back To 1928

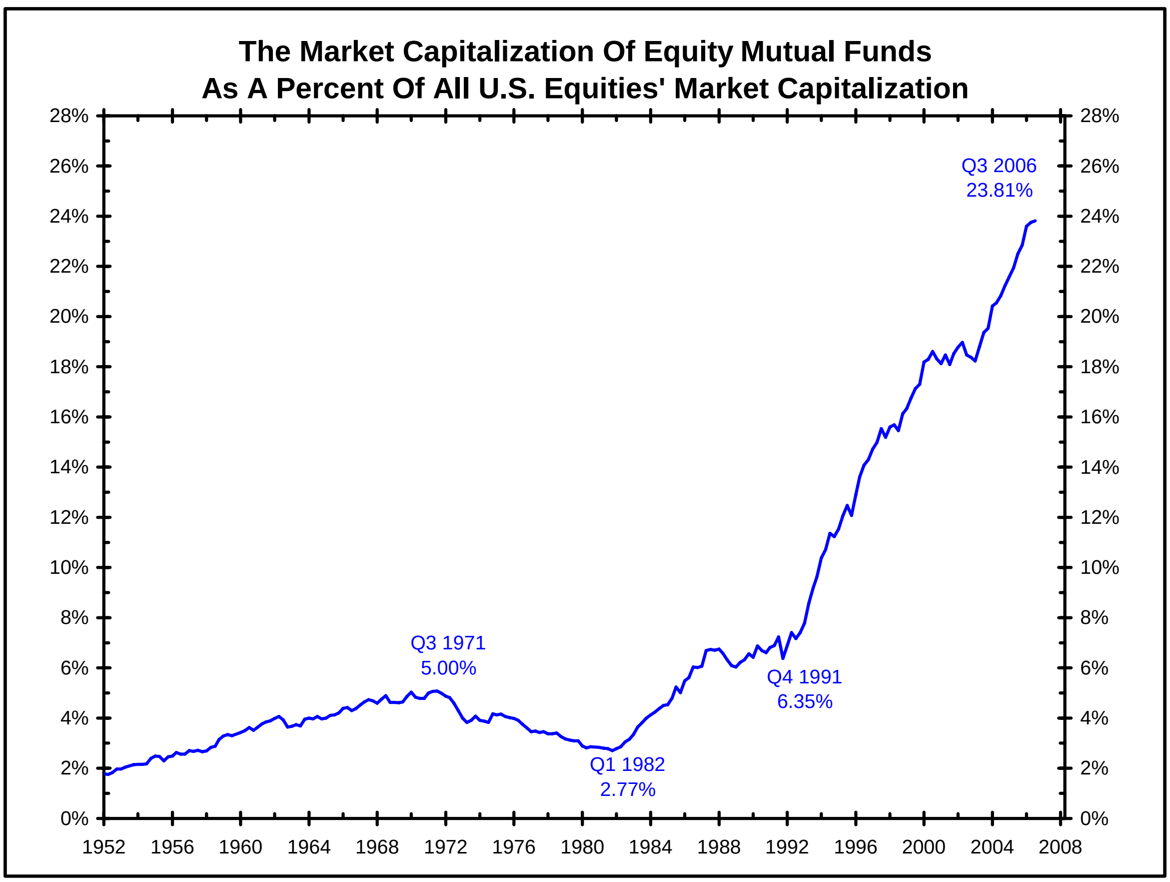
Starting Date	Ending Date	Actual Days	Trading Days	Gain
7/11/1928	12/6/1928	148	102	20.90%
5/14/1958	10/15/1958	154	107	21.59%
10/21/1960	4/24/1961	185	125	30.10%
11/22/1963	6/3/1964	194	131	14.19%
7/13/2006	***1/23/2007***	**194**	***132***	***16.37%***
12/8/1994	7/19/1995	223	153	25.72%
8/19/1953	6/8/1954	293	183	16.58%

The stock market is now 194 days into a rally without a 2% correction, an event which has occurred only once before in the last 53 years, in 1995.

Even more amazing is this rally is occurring while the domestically-oriented equity mutual funds were seeing outflows. We went to our database and looked up all the instances in which the stock market rallied at least 16% over a six-month period while domestically-oriented mutual funds had outflows. Over the last 30 years this has happened only **three times**:

- The six months ending June 1989. Here the S&P 500 gained 16.54% while domestically-oriented equity mutual funds had outflows of $600 million
- The six months ending November 1980. Here the S&P 500 gained 23.09% while domestically-oriented equity mutual funds had outflows of $4.4 billion
- The six months ending July 1978. Here the S&P 500 gained 21.77% while domestically-oriented equity mutual funds had outflows of $443 million

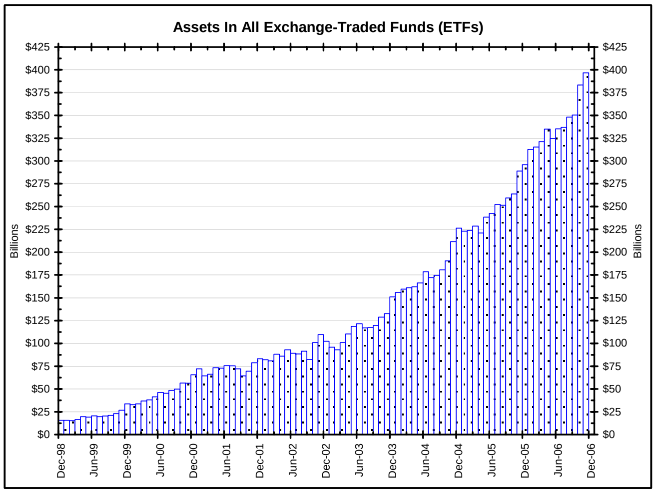
The big difference between now and 1989, 1980 and 1978 is the size and influence of equity mutual funds. As the chart below shows, domestically-oriented equity mutual funds now own nearly one-quarter of the stock market. Comparable numbers for 1989, late 1980 and mid-1978 were 6.9%, 2.8% and 3.4%, respectively. Currently, domestically-oriented equity mutual funds carry 7 to 8 times the weight they did in the late 1970s and early 1980s. **Most technical analysts that study mutual funds flows thought a rally of this magnitude while 25% of the stock market received no inflows was impossible.**

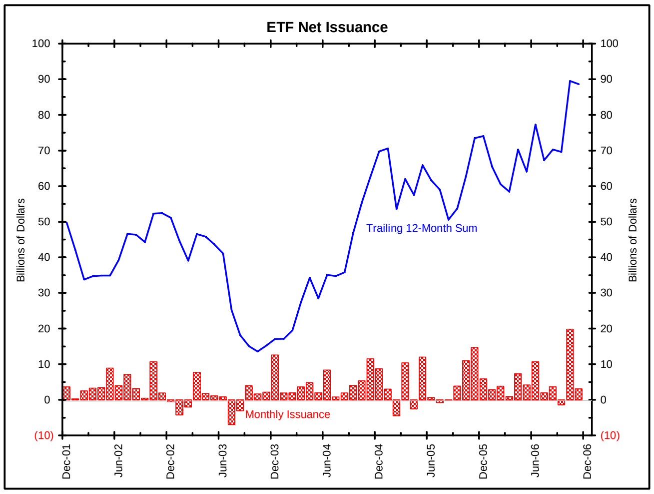


What About ETFs?

The natural thought is this money has shifted to other investment vehicles. The first one that comes to mind is Exchange-Traded Funds (ETFs).

The chart immediately below shows the total assets in all ETFs, including the relatively small global and non-equity ETFs. The second chart below shows the net issuance of all ETFs, the equivalent of net new cash flow for open-ended mutual funds.





Since May, all ETFs had a net issuance of $42 billion. Of this total, $19.8 billion of new shares were created in October alone (red bars, bottom chart).

The net of outflows from domestically-oriented equity mutual funds plus net issuance of all ETFs over the past six months is a net inflow of $16.7 billion.

In the second half of 2006, the total size of the U.S. stock market was nearly $18 trillion. Of this total, $4.8 trillion, or 26%, was held by domestically-oriented equity mutual funds and ETFs. Given these massive sizes, a total inflow of $16.7 billion over the last six months is a negligible amount. Or, to put it in perspective, this is about the same inflows seen in **one week** during the bubble period of 1999-2000.

What About Hedge Funds?

The other argument is hedge funds account for these “missing flows.” The problem with this argument is the nature of hedge fund investing.

Hedge funds are “alpha investors.” This means they are both long and short at the same time. Therefore the net exposure, or “beta” influence, on the market is actually tiny when compared to the $1+ trillion dollars in assets they command. In fact some measures that estimate their **net** exposure have it effectively at zero.

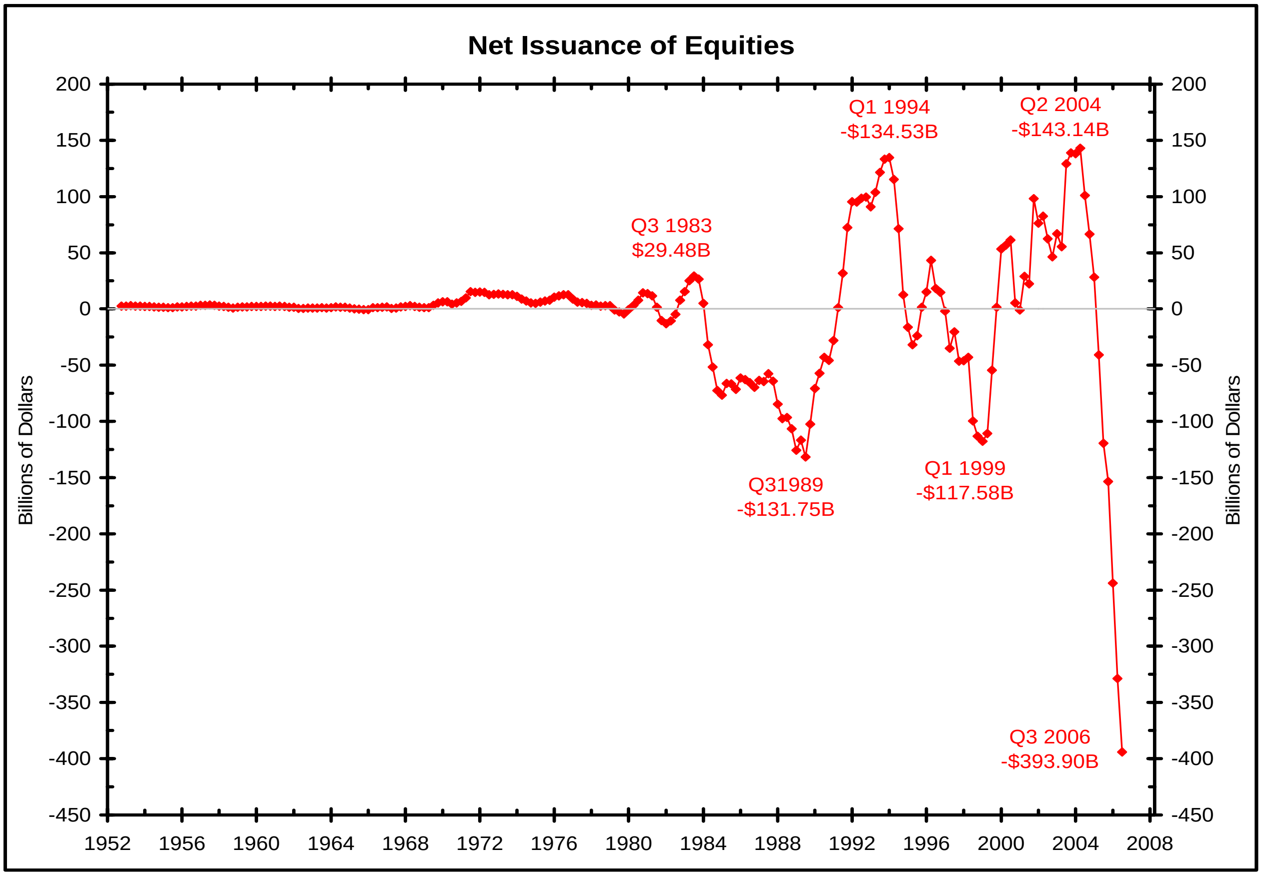
While hedge funds can distort sectors, trading relationships, or other internal dynamics, they are never on one side of the market like a mutual fund that is only long. Therefore, they do not exert pressure on the overall market to rise or fall to the same degree that mutual funds do.

Why Are Stocks Rallying?

We have proposed an interesting dilemma: A six-month stock market rally without a 2% correction while one-quarter of its investors are not participating. How can the stock market rally with this much “dead money”?

The chart on the following page illustrates the net issuance of all U.S. equities. It shows the total of initial public offerings (IPOs) and secondary offerings netted against stock buybacks and companies taken private.

In recent quarters the outstanding float of the stock market has been reduced by an unprecedented amount.



A reduction in float to this extent has the look of a liquidity surge. As companies are taken private, investors are paid and presumably reinvest some portion of their funds into an ever smaller pool of available stocks.

What is driving this trend? We believe it can be attributed to the popularity of private equity funds and the burdensome legal and regulatory environment that discourages offerings in the U.S. (Sarbanes-Oxley).

Conclusion

We have been trained to believe all stock market rallies are demand-driven. Investor commitment is the primary impetus for a rally, and investor withdrawal is the primary reason for a decline.

Now the U.S. stock market might be seeing the largest ever supply-driven rally. The float is being reduced at a record rate and investors are chasing a smaller pool of available stocks. What does it mean?

On the one hand, this is incredibly bullish. Typically, mutual fund investors' activity can be best described as "flows follow performance." If the market rallies, the money will chase it, adding to the rally. **We have so far seen a 16% rally without a 2% correction accompanied by no participation among mutual fund investors.** At some point we expect these investors to notice and start committing money. Then a real surge of liquidity will develop that can push stocks even higher.

On the other hand, it is bearish in the long-term. The reasons for the reduction of supply are a regulatory constraint and a potential mania in private equity. Both of these factors will continue to push stocks higher over the near-term, but left unchecked they can lead to overvaluation and unnecessary costs. We hope legislators will not view the rally in stocks as a sign Sarbanes-Oxley is a good thing, but hoping for this is like believing in the tooth fairy.

Lastly, it is important to recognize the rally both for what it is, a reduction of supply, and what it is not, an increase in demand. Too many commentators are trying to force a demand story of petrodollar money being recycled and Asian foreign exchange reserves being invested as the reason for higher markets. **We see it as the largest market in the world, at $18 trillion, rallying on reduced supply and no inflows. Those "missing inflows" are now supporting other markets.** Understanding this dynamic will better enable investors to see any coming bear market in the future. Waiting for the wrong idea (i.e., petrodollar recycling to stop) can lead to wrong conclusions.

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