Bad-News Bears Crash the Party

By GREGORY ZUCKERMAN

The Dow Jones Industrial Average has hit an all-time high. The Standard & Poor's 500-stock index is close behind. Stock prices remain reasonably priced based on many measures, individual investors are shifting back to stocks and corporate profits have been strong.

So what are a group of hedge funds and other investors doing? Selling.

Bearish-minded traders point to a variety of concerns, including the market's reliance on the Federal Reserve’s help, signs of excesses in corners of the bond market and froth in speculative shares. Some, like James Litinsky, even predict a recession over the next year because the recovery from the 2008 downturn is getting long in the tooth and the Fed won't juice markets forever.

"The rally is built on unprecedented government intervention," said Mr. Litinsky, who runs the $1.3 billion hedge fund JHL Capital Group. He is betting against a number of stocks and wagering on climbing Treasury rates. "The economy is fine right now, but there could be a trigger moment," such as the Fed reining in its bond buying, that could cause interest rates to go higher and stocks to tumble.

There is always a seller for every buyer, of course, and it is never hard to find a Wall Street pro with a glass-half-empty perspective. But as investors cheer the market's impressive gains, it can be instructive to pay some attention to the party poopers of the stock-market celebration.
Betting against the stock market, or just holding substantial amounts of cash, hasn’t been a wise move over the past four years. Just ask so-called long-short hedge-fund managers, or those who wager both on and against shares.

The average fund specializing in this kind of investing has scored gains of 4% this year through March 4, according to industry tracker HFR Inc. Other stock-focused strategies were up 5%. Over the past year, the average stock hedge fund has gained 4.5% versus a rise of 11.4% for the S&P 500.

Skeptics argue that stocks only look attractive relative to both risky and safer bonds and because investors are frustrated with the puny rates on their savings. This will end when central banks take the punch bowl away and reduce their activity, sending rates higher, bears say.

A cautious stance has cost John Brynjolfsson, who runs the $800 million hedge fund Armored Wolf LLC, which is up about 1% his year. He isn't turning into a bull, though. Mr. Brynjolfsson is focused on the continuing stalemate in Washington over controlling the nation’s debt as well as long-term worries about the ability of the global economy to grow. European markets have stabilized, but he points to continuing economic weakness in the region. Mr. Brynjolfsson's fund has purchased derivative positions that will rise if the S&P 500 falls.

On Wednesday, stocks were mixed, giving hope to both sides. The Dow rose 42.47 points to a record 14296.24, the S&P 500 gained 1.67 to 1541.46, but the Nasdaq Composite Index fell 1.77 to 3222.37.

Bulls scoff at the bear argument, noting that stocks aren’t expensive based on many earnings, dividend-yield and cash-flow measures. Until bonds begin to weaken and rates rise, many see little reason for concern.

Achur A. Iskounen, who runs hedge-fund firm Iskounen & Co., LLC, is worried about bonds, though. In 2007, when the stock market was last nearing a peak, investors ignored signs of trouble in riskier debt markets. Now, Mr. Iskounen noted that lower-rated companies are finding it easy to sell debt to investors. That is among the signs that investors are ignoring risks just to get their hands on investments with higher interest rates than safe debt, Mr. Iskounen said.

"The equity market is very detached from potential risks stemming from credit markets," said Mr. Iskounen, who calls himself "constructively bearish," or negative on the market but willing to buy a few stocks. His fund is up about 4.5% this year.

Some investors see a troubling divergence between the U.S., which is enjoying a rebirth in energy, manufacturing and housing sectors, and limp growth and looming troubles abroad. Shares of Yum! Brands Inc. which has a huge presence in China, are up just
more than 4% over the past year, while U.S.-focused Home Depot Inc. has soared more than 48%.

Sahm Adrangi, chief investment officer of Kerrisdale Capital, which has made money betting against Chinese and other stocks, worries about soaring shares of some smaller, more speculative stocks, which he said are a sign of the market's froth. One stock he is shorting: Opko Health Inc., a pharmaceutical and diagnostic-product company that is up 52% this year.

"The overall market doesn't seem overvalued," Mr. Adrangi said. "But we're seeing irrationality in a lot of speculative names."

Meanwhile, margin debt, or the amount of money that investors have borrowed to invest in stocks, is climbing. When this borrowing rises, it can suggest that individual investors are becoming too comfortable with risk, a sign the market is overheated.

Some heavily shorted stocks have been soaring, as these traders close out short positions by buying shares. That's not a reason to get excited about these stocks, some traders say.

For all their conviction, the bears realize it may be awhile before their dark predictions come true.

"Unfortunately, I am bearish and I have been wrong," said Samer Nsouli, chief investment officer at Lyford Group International, a hedge fund, who argues that recent weakness in copper and oil is a portent of a global slowdown. "Make no mistake, it will end in tears. The eternal question is when."

Write to Gregory Zuckerman at gregory.zuckerman@wsj.com