MARKET OUTLOOK

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Investor optimism does not match economic reality

In its latest statement, the Federal Reserve Open Market Committee tried to put a positive spin on the economic situation. But comments about "ongoing job losses, sluggish income growth, lower housing wealth, and tight credit" might lead one to believe there is yet little reason for optimism.

While U.S. Commerce Department reports showed 2009 second quarter GDP was better than expected, it still marked four consecutive quarters of negative growth.

The economy fell at a 1% pace, compared to expectations for a 1.5% drop. At the same time, first-quarter GDP was revised downward to -6.4% from the -5.5% previously reported. So it is quite possible that the second-quarter number could be revised significantly in later reports.

While many fundamental factors remain negative and indicate that the economy still faces many challenges, the technical picture is much improved.

When the current rally began in March, we warned investors to be cautious because surging advances during bear markets tend to become traps that quickly turn down and punish investors who jump in too soon. But the next leg of the bear market has so far failed to make an appearance. We saw a decline in June and it appeared our caution might be vindicated. But then stocks rose strongly again in July.

It is tough for a professional money manager to watch the market rise and realize that his clients are not participating. However, our foremost responsibility is to protect clients' assets against unnecessary risk and during this entire advance, risk levels have been and remain high.

In 2008 we anticipated the downturn and moved most client assets to money market funds. We sidestepped the major downturn and have largely watched from the sidelines ever since.

Now in 2009 major indices have finally recouped their losses from earlier in the year and are showing some gains. With media reports from some analysts saying that the bear market is over, investors who have been waiting on the sidelines are beginning to feel left behind. But just because there are a few signs of economic improvement does not mean the dan

ger is past.

As explained above, earnings on the S&P 500 are at an all-time low while valuation (as measured by the P/E ratio) is at a record high—far beyond any level ever recorded. Those are warning signals that would be irresponsible to ignore.

An Aug. 5 article on YAHOO! Finance posed the question: "Is This Rally Out of Sync with the Economy?" Author Simon Maierhofer explained that "For nearly five months, the major U. S. indexes ... have been climbing higher and higher. Simultaneously, economic numbers continue to disappoint."

The article also mentioned the disappointing corporate earnings and the valuations that are out of whack.

"Discerning the true value for stocks is actually quite simple, if you are humble enough to stick with a simple concept. During prior bear market bottoms of historic proportions, P/E levels, dividend yields, and mutual fund cash reserves have always reached levels indicative of a market bottom.

"Unless those indicators provide their stamp of approval, the market is overvalued and any rally will turn out to be short-lived. Based on those indicators, the market is grossly overvalued, still."

I have spent about 20 years in the investment industry. Prior to that, I worked 10 years as a hard news journalist. I can never recall another period where negative economic news was so easily dismissed. Nor can I recall another time when the tiniest glimmers of positive news were so eagerly touted and embraced.

No one at Strategis Financial Group professes to be able to predict what the markets will do. We can, however, compare past experience to current situations to help make decisions about what is likely to occur, based on similar historic events. During this current rally, the Nasdaq has been the strongest of the major indices. All technical indicators for this index are currently positive and if they remain so, at some point we will no longer be able to remain on the sidelines.

But we all know that markets are cyclical and right now, technical indictors are showing that a downward cycle might soon emerge.

On the front page is a two-year daily price chart of the Nasdaq. The rally we have seen over the past few months is clearly visible.

The middle portion of the chart is a Relative Strength Index (RSI). Notice that it recently approached 80. That is a very high level that is difficult to maintain. In fact, the only other time during the past two years that it neared this high level was in October 2007 and a significant downturn followed.

The bottom portion of the chart is a moving average convergence divergence (MACD). It is also at a highly overbought level, which normally would indicate that a downturn is overdue. But a closer look reveals that since April, the Nasdaq has spent most of its time at levels that would be considered overbought.

From a technical perspective, these indicators lead us to expect some sort of a market pullback, but it is impossible to know how much of a decline to expect. For several months major indices have resisted a significant drop, even though economic fundamentals show that the economy remains mired in recession.

If we see only a brief correction and then major indices rally again, we might cautiously enter a few long positions. But for the immediate future, the best course would seem to be to remain patient and wait for the right opportunity.

Markets advance in spite of dismal corporate earnings

For most of July, much of the media attention focused on the financial markets has been about corporate earnings. They are important, because the foundation of our capitalistic system is the concept that individual investors can participate in the profits of these corporations. Without earnings, there are no profits to share.

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Many of the media reports were about how second quarter earnings reports for many corporations have been better than expected. In fact, a report from Thomson Reuters news service showed that on July 24, with 30% of the S&P 500 companies reporting, only 16% of the companies failed to meet earnings expectations. Seventy-six percent exceeded projections and the remaining 8% matched expectations.

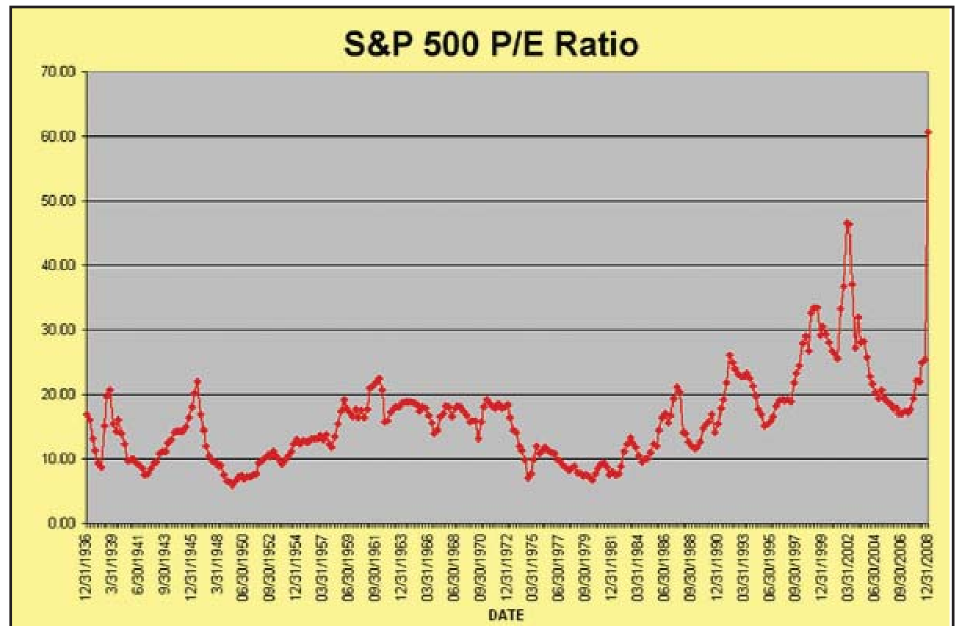
Unfortunately for investors, whether or not a company exceeds its earnings forecast says nothing about its profitability.

For example, consider this report from *Money Daily*: "After the bell on Tuesday, chipmaker Intel reported second quarter earnings results far ahead of Wall Street expectations. That was enough to give investors confidence that the economy was continuing to mend—albeit slowly—and that stocks—especially tech companies with strong balance sheets— would weather the storm and produce solid results."

Based on that commentary, one might assume that Intel was reporting a profit. In actuality, Intel lost 7 cents a share. That compared to a gain of 28 cents a share for the same quarter in 2008. Wall Street was expecting Intel to lose 8 cents per share. So the reported loss was better than anticipated.

Even though Intel lost money and overall earnings were down dramatically from the previous year, it was among those 76% of companies whose earning exceeded expectations. Intel closed at 16.83 the day before the report. The next day it gapped up to open at 17.99 and it closed at 18.05

In reality, earnings forecasts are not very important because the actual number can end up being far different than the forecast. The forecasts are the first glimpse of what the real quarterly numbers might turn out to be so they receive lots of media attention. Revisions made weeks later with more accurate numbers often fail to generate much interest or publicity.



A Jun. 19, 2009 report from Comstock Partners Inc. noted: "We are surprised to see so many analysts and portfolio managers discussing the first quarter's earnings for the S&P 500. Almost everyone believes that the earnings have come in above the forecasts and the only disappointment came from revenue shortfalls.

"We wrote a report on April 16th (the beginning of 2009 first quarter earnings announcements) about a discussion in the *Wall Street Journal* on whether the $13 of estimated 'operating' earnings for the first quarter would hold up. We concluded that the earnings would not match the estimate and we quote from the comment, 'we don't expect them to reach the $13 estimated for the first quarter.' Now that the earnings season has ended, the first quarter earnings are now a lot clearer and look to be just above $10. ..."

As demonstrated with the Intel example above, the corporations and Wall Street benefit when earnings exceed forecasts. It is to their advantage to make certain that their forecasts are conservative. It is kind of like asking students to choose their own grades. Given that opportunity, not many will fail.

The reality of the current situation is that no matter what the media is reporting, corporate earnings are dismal. Earnings per share of the S&P 500 are at their lowest levels since 1936.

The chart above shows the quarterly P/E ratio of the S&P 500 based on trailing 12-month earnings. This information comes directly from Standard & Poor's. At the end of 2008 (the last quarter for which final data is available), the P/E ratio of the S&P 500 was at 60.70, its highest recorded level.

Although final data was not available to include in this chart for the past two quarters, on the Standard & Poor's web site as of June 30, 2009 the P/E ratio of the S&P 500 (based on as-reported earnings) was reported as 134.01--more than double the highest level shown on this chart. Historically, the all-time average P/E ratio of the S&P 500 has been about 15.

The P/E ratio can be reflective of a company's financial strength or weakness. It is calculated by dividing a company's stock price by its earnings per share. Stocks with lower P/E ratios are generally assumed to be more attractive. While a low P/E is not a guarantee that a stock will perform well, it can be a useful tool to help assess earnings potential. Since the stock price also reflects the investors' expectations regarding the growth and future development of a company, a high P/E can be the result of investors' speculation.

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Most financial advisors would recommend that their clients avoid stocks with high P/E ratios because it is an indication that the stock is overvalued and carries potentially high risk.

For example, at the end of 1999 when the technology sector reached its highest levels of "irrational exuberance," Microsoft (MSFT) shares were trading at about $60 with a P/E of 76. A year later the share price had declined to $23 and the P/E was 30. Today the share price is about $24 and the P/E is about 14.

In this instance, the high P/E ratio of the S&P 500 is primarily reflective of a lack of earnings rather than of high investor expectations. Let the significance of that sink in for a minute or two. Standard & Poor's describes the index as: "the best single gauge of the U.S. equities market, this world-renowned index includes 500 leading companies in leading industries of the U.S. economy."

And since peaking in the third quarter of 2007, earnings for this icon of the U.S. stock market have fallen more than 95%. Never in the 86-year existence of the index have earnings been at this low level.

In spite of the fact that earnings have never been this low, the S&P 500 has risen more than 40% since bottoming at about 676 in March 2009. If the index were currently trading at the historical average of about 15 times earnings, the S&P 500 would now be well under 100, rather than approaching 1,000.

What does all this mean for Strategis Financial Group and its clients? For us it is just additional evidence that market risk remains high. At some point improving technical indicators could cause us to begin to ease back into the markets no matter the P/E ratio of the S&P 500.

Technical and cyclical indicators show that the current move is very extended. Virtually all economic fundamentals still reflect weakness and high risk for investors. We continue to anticipate that a sharp and severe market correction remains a possibility. It might not occur, but we must continue to follow a risk averse strategy under these conditions. Eventual re-entry into the equity markets must be cautious and measured.

—Flint Stephens

Mr. Stephens is marketing director and a financial advisor for Strategis Financial Group. He has been a writer and editor for numerous investment publications. He has a masters degree in communications from Brigham Young University.

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