

The Media Epidemic

On January 31, 2002, we advised our readers that the threat of terrorism within our own borders was actually quite small, and we wrote that we were “willing to bet that the United States will not fall prey to another major terrorist attack in the near future.” Few agreed with us, and no less an authority than the Vice President of the United States warned Americans to expect more terrorism on U.S. soil in the immediate future, saying in a May 20th interview that an attack was “almost certain... not a matter of if but when.”

It has been almost one year since Vice President Dick Cheney uttered these words, and nearly two years since 9/11, and yet we have not suffered any major terrorist incidents on U.S. soil. Once again, our favorite investment maxim is proving reliable: 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.

Media coverage of the Severe Acute Respiratory Syndrome epidemic is just the latest example of how people evaluate danger based on the extent to which the press dwells on it rather than statistical probabilities. As we have advised our readers time and time again, the intensity and duration of media attention devoted to any major news story is *inversely* related to the probability of that story having a material, long-term impact on your portfolio, and SARS is unlikely to prove an exception to this rule in the months ahead.

The process underlying this phenomenon is easy to understand: (1) The modern media makes almost everyone on the planet aware of important information immediately; (2) when provided with significant information, especially that which might pose an imminent threat to personal safety, people take action quickly; (3) the sooner people act on the information, the faster the threat is eliminated, or at least greatly reduced.

Uncomplicated though this might be, few can escape the powerful emotional pull of the media sirens. Anything with the words “severe,” “acute,” and “syndrome” in it has to be a serious problem and must be deserving of extreme caution, even if there is no evidence that it is spreading in any community in the United States. Travel advisories have been issued, flights have been cancelled, and hotel bookings have plummeted. One friend of ours told us earlier this week that she was apprehensive about getting too close to her own *grandmother*, who is visiting from China.

Are people overreacting? Probably. But regardless of whether these are sensible safety measures or manifestations of needless worry, one thing is certain: In combination, these actions greatly reduce the *actual* threat posed by this disease, even while media coverage of the danger continues to escalate.

As was the case with the “imminent” terrorist attacks that the media has been warning us about since 9/11, the number of Americans who are actually at risk for SARS is very likely being distorted and magnified by the press, and in this comparison you should find ample reason for going on with your life without a surgical mask – or duct tape, for that matter.

While we might wish for the press to provide coverage in proportion to a reasonable and rational estimation of the potential impact of events while also acting quickly to reassure us with accurate statistical data, savvy investors know that media hype and hysteria is actually quite valuable, insofar as it tells us what we *don't* need to worry about.

What About Japan?

There is no question that concerns surrounding the SARS epidemic have had a material adverse impact on some businesses and have rocked Asian financial markets. We are painfully aware of this, given that the Nikkei has declined more than 6% since February 28, when we recommended Japanese stocks as a compelling long-term investment. (The Nikkei is down nearly 9% year-to-date, versus an increase of more than 4% for the S&P 500.)

SARS was a surprise – neither us nor anyone else saw it coming, and the focus of the world on the war in Iraq no doubt helped the Chinese government keep the severity of the outbreak under wraps for as long as it did. As the Asian financial markets priced in the likely impact of SARS on regional economies and individual sectors, stocks tumbled.

But having become front page news, SARS has lost much of its power to impact markets. It is no longer a surprise, and the extreme reaction of people all over the world to this latest threat suggests to us that the next major SARS-related surprise will be how quickly it has abated.

To be sure, other factors have also conspired against Japanese equities. The diplomatic impasse over North Korea's nuclear-weapons program and disappointing earnings reports from Japanese

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corporate giants have slammed stocks. Just last week, Sony reported shockingly weak earnings, and shares in the world's largest consumer-electronics company plummeted 27% in just two trading days.

In spite of the confluence of negative events impacting Asian markets, nothing has changed with respect to our fundamental long-term outlook for Japan. Earlier this month, a Merrill Lynch survey of more than 300 fund managers world-wide showed Japan as the *least* popular region, behind Europe, the U.K., the United States, and emerging markets. If that doesn't sound bullish, look back and try to find a time when the majority of money managers was right. Good luck.

Underneath the surface, fundamental reasons for Japanese stocks strengthening are emerging, even though they are obscured by the gloomy headlines. Last year, Japanese companies were net buyers of their own stock for the first time in *twelve years*, purchasing \$20 billion, and Japan is one of the few regions in the world in which merger and acquisition activity is on the rise – there were more than 2200 mergers in Japan last year, a new record.

As we outlined in last month's issue of *fcNOTES* ("Where Demand Meets Supply," February 28, 2003), stock prices are determined by supply and demand. As supply falls and demand increases, prices move higher, regardless of how bleak the surrounding economic landscape might appear. From this standpoint, the acceleration of M&A activity in Japan (reducing the supply of stocks) combined with rising stock buybacks by corporations (increasing demand for stocks) is a very encouraging sign. If these trends continue, look for Japanese stocks to resume the leadership position they held last year.

200-Day Moving Average Confirmation

On April 22, solid gains on higher volume put all the major averages above their respective 200-day moving averages. The small-cap Russell 2000 index, which has underperformed the big cap indices so far this year, moved sharply above its 200dma to a level not seen since early January. The Dow Jones Industrial Average, S&P MidCap 400, and Dow Jones Utility Average also closed above their respective 200dmas, joining the Nasdaq and the S&P 500, which were already trading above this level.

This marked the first time since the fall of 2000 that *all* of the major averages were above this long-term benchmark at the same time. Significant? We think so.

On October 31, 2002, we increased our recommended equity allocation to 60%, and in November we told our readers that, "If the Dow, S&P 500, and Nasdaq can all break out above their respective 200-day moving averages and find support there, we will deem this to

be technical confirmation of our bullish outlook and finally recommend a fully-invested position."

As of today, we believe that the major averages have indeed found support above what has been an important resistance level throughout the bear market. After exploding 12% higher from its March lows, the S&P 500 slammed into its 200-day moving average and fell hard. But six days later, buyers took over again, and since then the S&P 500 has marched well above its 200dma – not since early September 2000, when the S&P 500 was near its all-time highs, has this average risen above its 200dma by more than 4.5%, yet that is where it is today. The Nasdaq has held up above its 200dma for more than six weeks, and the Dow has successfully tested its 200dma, finding support there after a two-day sell-off on April 24 and 25, before moving sharply higher to challenge 8500.

You can be certain that we are not the only ones watching the moving averages; the longer the indexes trade above their 200-day moving averages, the more pressure short sellers will feel to close out bearish positions by purchasing stocks, a process that will drive prices higher still. In our last newsletter, we explained how short sellers are an early source of demand for stocks in a depressed market: "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."

As the major averages have moved towards big resistance at the 200dma, short sellers have piled on. In April, short interest on the Nasdaq rose for the fourth consecutive month to a record high of nearly 4.5 billion shares, and short interest on the New York Stock Exchange rose by 1%. Short sellers are betting that the "war rally" is over and that concerns about the economy and corporate earnings will once again weigh on the market. If they are wrong, the new short interest will only add fuel to the next move higher.

Of course, we should point out that Q1 earnings for Standard & Poor's 500 companies have been surprisingly strong, even when one takes into account the common practice of low-balling projections to make the reported profits seem more impressive when they are announced. According to Thomson First Call, the more than two-thirds of S&P 500 companies that have reported earnings have beaten analysts' consensus estimates by 6.9% on average. That is more than twice as much as the nine-year average of 2.7%. On top of this, there have not been any shocking surprises; none of the S&P 500 companies has missed by a large number.

The bears argue that most of the improvement in earnings is due to cost cutting, not sales increases, and we do not disagree – revenues are up a mere 2% on average, versus a 12% gain in profits. And the pessimists are quite correct to observe that earnings

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growth cannot be sustained by cost-cutting alone over the long run. Again, we agree.

The difference of opinion is whether or not companies can boost revenues in the months ahead, and we believe they can.

Lost amid the flurry of earnings reports is that fact that few companies have taken the opportunity to slash their estimates for the rest of the year. Given the conservative nature of corporate reporting in the wake of Enron and other massive scandals, this strikes us as very positive. Stepping back, monetary policy is as accommodative as it has ever been, and short-term interest rates are at the lowest level since the early 1960s. With Fed Chairman Alan Greenspan signaling his willingness to allow rates to fall even further if necessary, and President Bush renewing his push for additional fiscal stimulus now that the war in Iraq is largely over, conditions for an economic recovery are as good as one could hope for.

From a technical standpoint, we will continue to watch the 200-day moving averages. Failure by one or more of the major indexes to hold support at this level will be of concern and will cause us to revisit our recommendation that investors maintain a fully-invested portfolio. But as of today, we are finally advising readers to allocate *all* remaining stock market cash reserves and become 100% invested.

The best is yet to come.



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