

Surprising on the Upside

DON'T WORRY ABOUT ALL THE TALK YOU hear about another tech bubble, or that the stock market has run too high, too fast. Sure, we could get some scary short-term pullbacks, but I'm expecting this market to continue surprising folks with stronger than expected performance. When it comes to predicting the market, I look to sentiment, fundamentals, history and technical indicators. I still like what I'm seeing.

CONTRARIANISM WORKS

Research has shown that there is an inverse correlation between Wall Street sentiment and stock market returns. A study by Ken Fisher and Meir Statman, based on Merrill Lynch sell-side recommendations from 1985 to 1998, found that an increase of 1 percent

in the sentiment level of Wall Street strategists is associated with an average decline of 0.24 percent in S&P 500 returns the following month. As we enter the second half of the

year, analysts remain conservative and worry that the market has gotten way ahead of itself. It's just what you would expect to hear from the same folks who were hammered so badly in the bear market for being too positive. Expect stocks to surprise on the upside of what is now overly conservative analysis.

POSITIVE FUNDAMENTALS

Although professional sentiment is cautious, the fundamentals have seldom looked more positive. Corporate cost structures remain lean, as evidenced by the improvements in earnings over the last two quarters. In addition, the second quarter saw top-line growth as the revenue picture improved. Expect revenues to keep improving as a flood of fiscal and monetary stimulus makes its way into the economy. Yes, the job market is weak and consumer confidence mixed, but employment is a lagging indicator and there is no statistically meaningful relationship between confidence numbers and economic performance. In other words, the fundamentals that matter look very solid.

SOLID TECHNICAL INDICATORS

There are a lot of technical indicators worth paying attention to, but one of my favorites remains the 200-day EMA, which is a weighted average of the last

200 days of closing prices. As I write this column at the end of July, all of the major indices – S&P 500, NASDAQ, Dow Jones Industrial Average and the Russell 2000 – remain comfortably above their 200-day EMAs, something not seen since 2000. In addition, the S&P 500 and Dow Jones Industrial Average remain well above the inverted head-and-shoulders bottoms I wrote about in my June column. Volume has also remained positive, as the post-March rally has exhibited strong volume on positive days and set higher highs and higher lows.

THE FUTURE IN THE PAST

A big reason I was so positive in January on my 2003 outlook is the fact that only the Great Depression has seen four calendar years of negative stock market returns, and I've yet to see any bread lines on my way to the office. History also puts the heavy levels of insider selling we've seen in perspective; unlike Wall Street analysts, the transactions of corporate insiders are usually an accurate predictor of where the market is going. Heavy insider selling, like we've seen over the past several weeks, usually precedes a substantial sell-off. Of course, the key word here is "usually." Financia Capital's research into the double-dip recession of the early 1980s revealed that after insiders got faked out by a false economic start in 1982, they sold into one of the strongest rallies of all time throughout 1983 and beyond. My opinion is that history is repeating itself today and the recent false start in 2002 has caused once-burned insiders to sell into a real rally. In other words, such economic cycles are the exception to a usually dependable rule.

On a final note, right now I'm sticking to the December column's prediction that a semiconductor industry upturn would begin in the second quarter of this year. Hopefully, by the time this column goes to print, revenue growth will be further accelerating and Q2 will be seen as a turning point. On the other hand, though my July column successfully called the recent top in bonds, I'm going to back off from the "bubble" analogy. Prices probably needed to go even higher to create a true bubble, although they were clearly too high to justify the risk. ☺

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