A Tale of Three Cities: Macro, Micro, and Technical

The market swooned in the last half of the second quarter on fears of a global slowdown in macro economic activity. An analysis of micro economics suggests that stocks are cheap. The technical picture has deteriorated but not unexpectedly so. Hence, we have a Tale of Three Cities.

The S&P 500 peaked at 1218 on April 23rd and closed the quarter on June 30 at 1032, a decline of just over 15%. It was a volatile period.

Let's look at the Macro:

Concern over debt levels in Europe cause a plunge in the value of the Euro

Tightening by the Chinese to cool an overheated housing market causes global growth concerns

The oil spill in the Gulf raises environmental concerns and the subsequent halting of off shore drilling causes oil supply concerns

Financial regulatory reform creates uncertainty in our financial system

Budget deficit fears and concern over tax increases

Fear of slowing retail sales

Lack of Job Growth…Housing still weak

I could go on but you get the picture. There is a lot to worry about on the Macro front and the market is reflecting those concerns. I could debate every one of these points and talk about the credit cycle and how recoveries rarely are V shaped, etc., but it would not matter because I am not a macro economist. Indeed, my focus is on micro.

The Micro picture is much different:

Corporate balance sheets loaded with cash, about a trillion dollars.

Earnings troughed over a year ago and were up 99% on an equal weighted basket of 2101 names. By the 1st Q of 2010 we will exceed the peak in 2006.

The yield on 5 and 10 year treasuries is historically very low in relation to the earnings yield and dividend yield on stocks

Earnings and sales for the consumer, manufacturing, and technology sectors are exceeding expectations, causing estimates to be raised

The market is historically cheap relative to its growth rate and the potential for inflation

There is a lot of good news to report around the globe as well. China, Brazil and India are booming. There are large global growth forces such as the rise of the middle class that will drive earnings for large multinational companies for years to come.

Lets' look at the technical picture. Technicians study price and volume drawing conclusions about the future from historical price patterns and trends.

The S&P 500 bottomed at 666 in March of 2009 when it looked like the financial system as we knew it was about to implode.

The market rallied to 1218 in April 2010. That is an increase of about 83 percent!

Now I am not an expert at calling tops or bottoms but you have to admit that that was one huge move. Technicians say that the move must be consolidated and the weak hands need to be shaken out before the market can move higher. Ok, well if we gave up 50% of the up move or 276 S&P points that would give a value of 942 on the S&P or about 8% below current levels.

Now we know that the up moves come fast and furious and you have to be in the market to get them. So why risk an additional 8% correction that may not occur and give up a big move to the upside?

Taking a longer term view the S&P was at 430 on June 30, 1995…15 years later it is at 1032….plus dividends…on June 30, 2000, ten years ago, it was actually higher! 1231. My bet is that the next five years could make up for lost time. The five year treasury yields less than 2 %, or less than the dividend yield on the market. Would you lend the US government money right now for 2% a year for 5 years versus buying the market with a 2% dividend yield and the potential to substantially grow earnings and dividends?

I look at technicals because they drive psychology and that is important in the short run. However, over our longer tem investment time horizon stock prices correlate with earnings, hence the focus on micro economics.

In my opinion the micro factors will ultimately win out over the macro and technical factors. Prices will follow the fundamentals of businesses. Those fundamentals look pretty good in relation to prices right now.

Please fell free to call or email bhutchens@hutchco.net with any questions or comments. Have a great summer!

Sincerely

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