Topical Study #82
A Dozen Good Reasons To Be Bullish

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I. Happy Anniversary!

The S&P 500 bottomed at 666 on an intraday basis a year ago on Friday, March 6, 2009. On a closing basis, it bottomed at 676.53 on Monday, March 9, 2009 and is up 68.3% since then to 1138.70 on Friday, March 5, 2010 (Figure 1). That's the best 12-month performance since the early 1930s. I am pleased. My only disappointment is that the S&P isn't at 1332, which would have been a doubling of the devilish intraday bottom exactly a year ago. However, I am a patient man. I still expect to see the S&P 500 between 1300 and 1350 before the end of the year.

Over the past year, there have been lots of skeptics. The notion that this has been a sucker's rally has been around since it started. The following is from the March 23, 2009 issue of *Forbes*:

> Is this a sucker's rally? Let's ask Nouriel Roubini. He seems to have as good a handle on this as anyone else. As reported by *Forbes*, Roubini accurately predicted last September that a then-nascent rally would prove fool's gold. He was right, as the Standard & Poor's 500 has fallen 39% since then. Following that, he correctly predicted that rallies at the start of the year would also prove short-lived. Most recently he predicted, on March 12, that the current rally, brewing since March 9, would not last, fizzling under the 'onslaught of worst than expected macro news, earnings news and financial markets/firms shocks.' Still, the recent rally has been impressive, with the Dow Jones industrial average rising 9.8% since hitting 52-week lows on March 9.

In the May 12, 2009 *Wall Street Journal*, Andy Kessler wrote an op-ed titled "Was It a Sucker's Rally?" He answered the question in the affirmative without any hedges:

> The stock market still has big hurdles to clear. You can have a jobless recovery, but you can't have a profitless recovery. Consider: Earnings are subpar, Treasury's last auction was a bust because of weak demand, the dollar is suspect, the stimulus is pork, the latest budget projects a $1.84 trillion deficit, the administration is berating investment firms and hedge funds saying 'I don't stand with them,' California is dead broke, health care may be nationalized, cap and trade will bump electric bills by 30% . . . Shall I go on?

It hasn't been a sucker's rally. It started out as a relief rally following a major bear market. The S&P 500 peaked at a record 1565.15 on October 9, 2007. It dropped 20.0% to 1251.70 by Friday, September 12, 2008. The following week, AIG and Lehman collapsed. The S&P 500 fell another 39.9% to a 2008 low of 752.44 on November 20. It rallied through the end of that year, rising to 903.25 before plunging yet again by 25.1% to the March 9 closing low. All in all, it lost 56.8% from peak to trough. The final selloff indicated widespread capitulation and revulsion with owning stocks, especially in the Financials sector (Figure 2). Banks were trading as though they were all going to be nationalized.

That didn't happen. Instead, the banks succeeded in raising lots of capital. That happened because money poured into the bond markets as investors and depositors scrambled to get better returns than were available in the money markets after the Fed lowered the federal funds rate down to zero on December 16, 2008. The three-month Treasury yield has been below 0.50% since October 29, 2008 (Figure 3). The relief rally was led by the Financials as investors concluded that the Doomsday scenario was becoming less likely.

During the spring and summer of 2009, investors responded favorably to “green shoots” that were popping up in the economic indicators. Better-than-expected Q1-Q4 earnings reported during April, July, October, and January also helped to send the S&P 500 higher to 1150.23 on January 19. It then sold off 8.1% to a low of 1056.74 on February 8 as investors worried about the outlook for China and Greece. On Friday, March 5, the S&P 500 was back up to 1138.70, only 1.0% below the year’s high. Will it keep going to 1300-1350 before the end of this year? That’s my prediction.

II. The Magnificent Dozen

Last year, I turned bullish a few days after the S&P 500 bounced off 666. I observed that commodity prices were firming. Bank earnings were starting to improve. I was especially encouraged by news that the mark-to-market rule might be suspended. (From late 2007 through early 2009, I had often written that this rule was the major contributor to the downward spiral in the earnings of Financials and to the bear market. I was so concerned that I had even lobbied my Congressman to do something about it. See Table 1 below for more on this subject.) I also noted some signs of Gridlock in Washington, which I viewed as a bullish development. As the bull market progressed, I turned increasingly upbeat on the outlook for earnings and stock prices.

Over the past year, I have often updated my list of reasons to remain bullish. To maintain my objectivity, I also regularly update the Worry List, the most recent version of which appears in Table 2. Over the past year, I have consistently argued that the positives should trump the negatives. I still think so, and here is my latest list of a dozen reasons to remain bullish:

1) **Sentiment** remains bearish for stocks, which is usually bullish. Most investors are convinced that “this will all end badly.” However, the bears have yet to stage a serious correction in stock prices. Individual investors remain especially cautious on the stock market. Last year, bond mutual funds attracted a record $443.6 billion in net inflows, while equity mutual funds attracted only $45.6 billion. Equity funds that invest only in the US had net inflows of only $0.8 billion. From 2004 through 2007, equity funds attracted $191.8 billion, per year, on average (Figure 4).

2) **Liquidity** is more than sufficient to push stock prices higher. Retail money market funds had net outflows of $274.3 billion over the past 52 weeks through the week of February 22, but most of that went either into bond mutual funds or into savings deposits (including Money Market Deposit Accounts), which soared $622.3 billion over the past 52 weeks to a record high of $4.93 trillion (Figure 5). Money market funds held by institutional accounts totaled $2.08 trillion during the week of February 22.

3) **Corporate cash flow** rose to $1.52 trillion during Q3-2009, matching the previous record high during Q3-2008, according to the National Income and Product Accounts (NIPA), It undoubtedly rose to a new record high during the fourth quarter and should continue to do so this year (Figure 6).

Among the most aggressive buyers of equities recently have been companies buying other companies for cash. The 382 nonfinancial firms in the S&P 500 that have reported results for Q4-2009 are now holding $932 billion in cash and short-term investments, according to a *Wall Street Journal* analysis of data from Capital IQ. That sum is up 8% from the third quarter and up 31% from a year ago. Through the first two months of the year, the percentage of all-cash deals in the US more than doubled from 2009, according to an analysis by Thomson Reuters. Nearly 50% of deals this year have been all-cash offers, up from 24% of deals in 2009 and on par with 2006 and 2007, when credit was in oversupply.

4) The **Fed** is likely to maintain its zero interest rate policy (ZIRP) for an extended period, making liquid assets less compelling to hold than stocks. In his prepared testimony for the House Committee on Financial Services released on February 10, Mr. Bernanke repeated the Fed's mantra: "The FOMC anticipates that economic conditions, including low rates of resource utilization, subdued inflation trends, and stable inflation expectations, are likely to warrant exceptionally low levels of the federal funds rate for an extended period." The "extended period" phrase has been used by the Fed for an extended period, which could extend through the end of the year. It has popped up in every FOMC statement since the March 17-18, 2009 meeting of the Fed's policy committee.

5) **Earnings** should continue to rebound. Industry analysts who cover the S&P 500 predicted on February 26 that 2011 earnings will be $95.66 per share for this composite, up 20.8% from their current estimate of $79.21 for 2010 (Figure 7). When I do my P/E-times-E analysis of the S&P 500, I use forward earnings, which is a time-weighted average of analysts' consensus expected earnings for the current and coming years. This average will converge toward the 2011 consensus estimate by the end of the year. Of course, the current estimate for next year can change. Analysts tend to be too optimistic and, so they tend to lower their annual estimates over time. However, during the previous cyclical upturn in profits from 2004-2006, they raised their estimates.

6) **Valuation** is compelling, with P/Es relatively low for the overall market and for many sectors and industries. The forward P/E of the S&P 500 is currently 13.5, down from a recent peak of 15.0 during September. The series started during 1985, and averaged 15.1 since then using monthly data. Excluding the excessively high readings during 1999-2000, it averaged 14.5.

If the current earnings estimate for 2011 holds through the end of the year, then forward earnings will be about $100. The current forward P/E is 13.5 which would put the S&P 500 at 1350 at the end of the year. An alternative realistic scenario might be 15 times $90, which would also put the index at 1350.

7) The upturn in the **Profits Cycle** should revive employment and capital spending as it always has in the past. When profits are rising (falling), companies inevitably expand (reduce) their payrolls and capacity. There is a very strong correlation between the yearly percent change in S&P 500 forward earnings and the year-over-year growth in the Index of Coincident Economic Indicators (CEI). This index includes payroll employment, industrial production, real business sales, and real personal income excluding transfer payments (Figures 9 and 10). Forward earnings was up 23.5% y/y during the week of February 26, the best growth rate since March 1981.

The plunge in initial unemployment claims since last April confirms that the pace of firing has declined sharply as it always does when the economy begins to recover. February's survey of online job ads by Monster.com suggests that the pace of hiring may be starting to improve. The monthly ADP and BLS surveys show the pace of net job losses diminishing rapidly through February and suggest net gains are likely in coming months.

8) **Productivity** is growing rapidly and setting new highs. This suggests that real pay per worker will continue to do the same. There is a very strong correlation between nonfarm productivity and inflation-adjusted wages, salaries, and benefits per payroll employee (Figure 11). The former rose 5.8% y/y during Q4-2009 to a record high. The latter has flattened out in recent months at a record high. Real pay per worker is likely to resume, climbing along with productivity as the economy improves. This should lift consumer confidence and spending, especially since there is probably lots of pent-up demand.

9) **Global Economic Growth** should continue at a solid pace. The Greatest Global Boom of All Times (GGBAT) started after the end of the Cold War. During the 1990s, it was very much centered in the US, which also benefitted from the start of the High-Tech Revolution. Emerging economies continued to lag, and were hard hit by a series of financial crises during 1997 and 1998. The Tech bubble in stocks burst at the beginning of the previous decade. But the recession was short and shallow.

The second phase of GGBAT began after China joined the World Trade Organization on December 11, 2001. It was a truly global boom. The emerging economies finally emerged. They had enough critical mass and were growing so fast that the OECD's measure of global production significantly outperformed a comparable index for output only among the 30 advanced members of the OECD (Figure 12).

There was a brief intermission in GGBAT during the final few months of 2008 and the first few months of 2009. The Credit Insurance Fraud Industry collapsed during that period. However, the global boom is clearly making a comeback after the near-death experience.

10) **Leading economic indicators** around the world are bullish. In the US, the Index of Leading Economic Indicators (LEI) rose again during January. That's the tenth consecutive increase. It is up 9.5% over this period. The average increase over the same ten-month spans during the previous six recoveries was 7.6%, ranging from 4.4% to 13.8%. This suggests that the economy may be experiencing a relatively normal recovery rather than a "new normal" subpar recovery with stubbornly high unemployment. The LEI for the 30 advanced members of the OECD is up 12.3% over the past 12 months through January.

11) The **sovereign debt** crises around the world should force governments toward greater fiscal discipline. The fear is that the crises in Dubai at the end of last year and in Greece at the beginning of this year could be the start of another financial contagion. This is a reasonable concern. However, governments are starting to recognize that there are limits to deficit-financed spending, particularly on social welfare. A backlash against excessively generous pay and benefits for public employees is also underway in many countries.

12) In the US, **Gridlock** has scored several impressive wins over the past year. It is about to get tested again. It should prevail, with a historic victory likely on November 2 of this year. On that

date, I expect that there will be a major regime change in Congress as voters around the country make it clear that they want less government meddling in the economy and in their lives. This should result in a more fiscally conservative Congress.

III. Back to the Future

When the S&P 500 bounced off 666 a year ago, the Da-Vinci-Code Symbolist in me immediately recognized it as the bear market's low. The Strategist in me made a list of some bullish developments. In the Wednesday, March 11, 2009 Morning Briefing, I wrote:

> In recent days, I've suggested that the market was due for a good rally because sentiment was bordering on suicidal. I was hard-pressed for reasons why this might happen, though I did mention some possible triggers. After yesterday's rally, let's refresh the list with some of the factors driving up stock prices on Tuesday:
>
> (1) Positive earnings surprises are almost always bullish for stocks. In this environment, news that banks' operating earnings may be turning positive after several negative quarters is certainly reason for joy. Nevertheless, there is still a high risk that earnings will disappoint depending on mark-to-market losses on securities and rising provisions for bad loans.
>
> (2) A hint by Congressman Barney Frank that the SEC might reinstate the uptick rule in April helped charge up the bulls yesterday too. With the market down 50% from its peak, I think this is a wee bit late. But I have argued that the rule contributed to the rout, especially in Financials. So I welcome this possibility.
>
> (3) On Thursday, a House Financial Services subcommittee is scheduled to meet to consider possible incremental changes to the mark-to-market accounting rule. Yesterday, Fed Chairman Ben Bernanke called for 'improvements' in M2M rather than suspending the controversial accounting standard. Just do it, and improve it later!
>
> (4) More gridlock in Washington would be a welcome development for the stock market. This will be tested as Republicans and moderate Democrats are attempting to bury the unions' push for card-check legislation. There was certainly no gridlock stopping the pork fest in ARRA and the earmarks festival in the 'Omnibus' budget bill for the rest of the year.
>
> (5) The recent rise in the price of crude oil suggests that the overhang of excess supply is diminishing rapidly. It may also be a harbinger of improving global demand. The recent bottoming of commodity prices is another positive development.
>
> (6) The firming in commodity prices may reflect a pickup in China's economy in response to increased government spending on infrastructure to boost economic growth.

In the Monday, March 16, 2009 Morning Briefing, I wrote:

> We've been to Hades and back. The S&P 500 bottomed last week on March 6 at an intraday low of 666. This is a number commonly associated with the Devil. The market

soared from Tuesday's low to close up 13.6% last week at 756.55. The previous "bottom" was 752.44 on November 20. The latest relief rally was sparked by lots of good news for a refreshing change, which I believe may have some staying power:

(1) Citi's operating earnings turned positive in January and February. BofA and JPMorgan reported similar developments. The recent mortgage refinancing boom may continue to lift bank profits. The fixed-income investment banking departments may continue to collect lots of fees from the recent surge in issuance of corporate bonds. Last week, there was a total of $29.8bn of FDIC-backed bond sales, making it the second busiest week since companies began using the FDIC's Temporary Liquidity Guarantee Program on November 25, according to data compiled by Bloomberg.

(2) Congress is pushing the SEC to re-impose the uptick rule and ease up on mark-to-market (M2M) accounting. "Relax mark-to-market in three weeks, or we will do it for you." That was the message to the SEC and FASB from the key members of a Congressional subcommittee last Thursday. They suggested that relaxing, rather than suspending the rule might be the way to go. Last week, on CNBC, Warren Buffett supported the rule, but suggested a good compromise for the debaters. Keep M2M for financial reporting, but relax it for regulatory capital requirements. That makes lots of sense to me.

(3) Retail sales were surprisingly strong during the first two months of the year. January's number was revised by nearly a full percentage point from up 1.0% to 1.8%.

(4) M&A activity is picking up in the health care industry.

(5) Copper inventories on the LME slid 1.3% to a five-week low on Friday. Supplies are down 9.3% from a five-year high on February 25. Stockpiles monitored by the Shanghai Futures Exchange decreased 9.7% this week. The price of copper is up 18% this year on optimism that demand will rebound.

(6) Since mid-September through early March, liquid assets are up a staggering $1.0tn to a record $13.8tn.

(7) President Obama spoke for more than an hour last Thursday to the Business Roundtable of 65 top CEOs. He hinted that he might consider lowering the 35% corporate tax rate if he succeeds in cutting business tax loopholes.

(8) The Bank of England's initial experience with quantitative easing has been a success. The yield on the 10-year gilt dropped to the lowest level in at least 20 years in March, after policymakers announced the asset-buying program on March 5. Fed Chairman Ben Bernanke has indicated that the Fed is still considering whether to purchase Treasury bonds.

A couple of PMs told me at the end of last week, "It's nice to see some green on the screen for a change." It was a good week. The November 20 low wasn't THE low, but we closed above it on Friday. I'm rooting for more good news, and hoping that 666 was THE low.

* * *

Table 1. Suspending Mark-to-Market
(The following is an excerpt from the Monday, June 22, 2009 Dr. Ed's Morning Briefing)

Laura and David go to Washington. My wife and I took our kids (who are 8 and 10) to visit our nation's capital on Thursday and Friday. We started with a tour of the Capitol building that we prearranged through the office of our Congressional representative, Gary Ackerman. After seeing the Rotunda, we went up to the visitors' gallery in the House, which was very busy that day with members voting on numerous bills. Then, the Congressman's aid surprised us by whisking us downstairs to an entry door to the House floor. Mr. Ackerman came out and asked the kids to join him in the chamber. Needless to say, it was a great experience for them.

I first met with Rep. Ackerman in early November of last year, in his Congressional district office on Northern Boulevard in Queens, about 15 minutes from my home. He and his legislative assistant agreed to hear me out on why more needed to be done in Washington to bring mortgage rates down and why mark-to-market (MTM) accounting rules should be suspended. He is a senior member of the House Committee on Financial Services, which is chaired by Barney Frank. On March 12, the House Financial Services subcommittee held a hearing on MTM. Rep. Paul Kanjorski, who heads the subcommittee, warned the chairman of the Financial Accounting Standards Board that if his organization didn't fix MTM, Congress would. At the hearing, Congressman Ackerman reminded the man from FASB that Congress was considering a bill to broaden oversight of his organization. He told him to fix MTM in three weeks. On April 2, FASB did just that. (For a full account, see "Congress Helped Banks Defang Key Rule," in 6/3 WSJ.)

Table 2. The Worry List
(The following is an excerpt from the Monday, February 22, 2010 Dr. Ed's Morning Briefing)

"So what is everyone else worrying about?" This is more or less the most frequent question I've been asked in recent visits and phone conversations with our accounts. This happens after we've spent some time discussing everything that there is to worry about. Currently, the Worry List includes 10 issues. I think they will be sorted out without the dire consequences that are widely feared. I've discussed them all in recent weeks. Here's the list with a few of my takeaways:

(1) ***The Sovereign Debt Worry***. The subprime mortgage problem was widely recognized and underestimated in 2007. It led to a severe financial contagion that nearly caused a depression, which was averted by government bailouts. But who will bail out the governments as they submerge under more and more debt? Is Greece the subprime sovereign debt problem that turns into a contagion? I don't think so. With short-term interest rates so low, the demand for government bonds is likely to remain high. Tax revenues should recover along with incomes and profits in most countries. Of course, pressure on governments to reduce their deficits would be a good thing.

(2) ***The Gridlock Worry***. The US government is dysfunctional. It was designed to be so by the Founding Fathers. The system of checks and balances often frustrates power grabs by various factions. The Democrats are running into stiff resistance to their controversial legislative plans for health insurance, cap-and-trade, and card check. That's a good thing. However, Gridlock also means that the Bush tax cuts will likely expire at the end of this year. That's not good for the economy, which is more likely to slow than to double dip in 2011.

(3) ***The State & Local Budgets Worry***. Widening budget deficits are unconstitutional in most states. This problem was postponed for many of them by infusions of cash provided by the federal government through the American Recovery and Reinvestment Act of 2009 (ARRA). More cash will be available this year, but states will have to cut their spending, especially on public employee pay and benefits, as taxpayers resist additional levies. Again, why is this a bad thing?

(4) ***The Commercial Mortgage Worry***. Losses are mounting in the commercial real estate market. It is a cyclical industry that has its booms and busts. A large building complex in Manhattan just went under with losses likely to exceed $2bn. That's bad news for the sellers, but a good deal for the new buyers. There is plenty of cash around in vulture funds to scoop up distressed assets. Commercial property markets are clearing, though not without pain.

(5) ***The Exit Strategy Worry***. The Fed is formulating its exit strategy. So are other central banks. The Fed will stop buying mortgage-backed securities in a few weeks. The Chinese are tightening their credit policies. The US government still has plenty of stimulus money to spend from last year's ARRA, but it will be mostly spent by the end of this year just when the Bush tax cuts expire. Then again, governments usually stop stimulating once their economies recover, as long as growth is self-sustaining, which it is normally and should be again.

(6) ***The Inflation Worry***. The worry is that massive monetary stimulus to avert a depression will soon trigger an inflationary rebound. Japan demonstrates that deflation can persist despite easy money if the banking system is impaired with bad loans. Unemployment is likely to remain high for quite a while, which will depress wage and rent inflation.

(7) ***The China Worry***. This concern is a variation of the common view that economies may not be capable of self-sustaining growth and may require ongoing government stimulus to keep growing. Chinese monetary authorities are clearly attempting to engineer a soft landing for their economy. Investors are jittery that a hard landing might occur instead, even though the Chinese have managed their economy much better than most other governments in recent years.

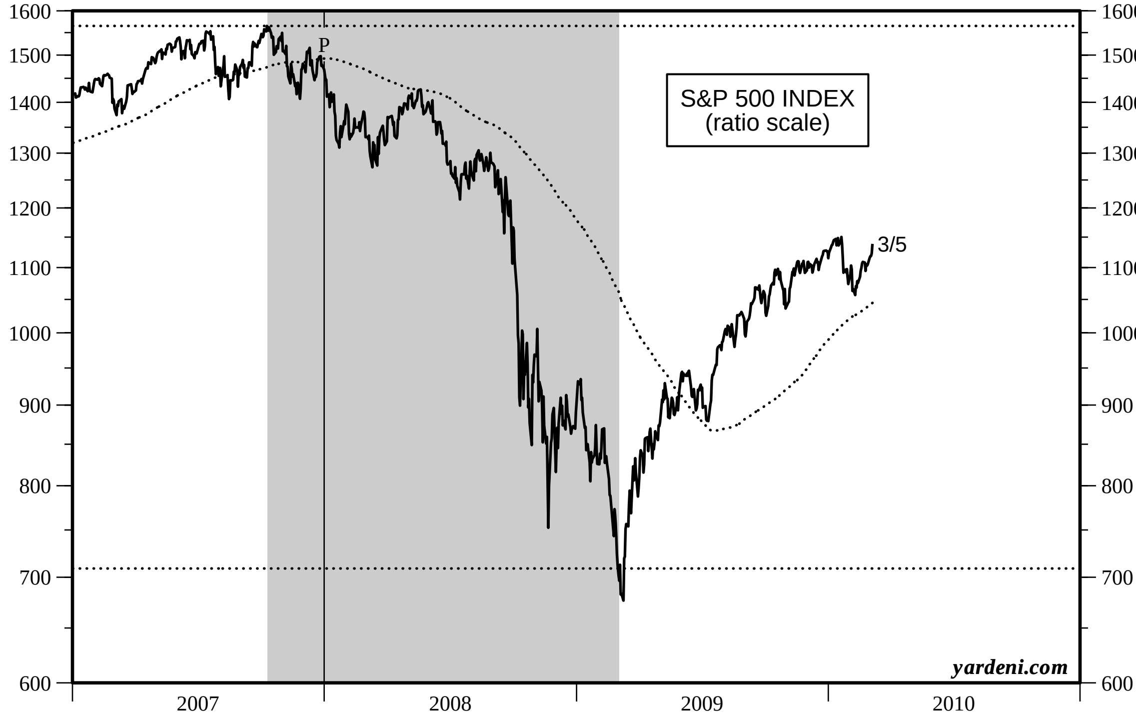
(8) ***The Employment Worry***. There is clearly a structural employment problem in the US. It even made the front page of the Sunday NYT yesterday. The unemployed are staying that way much longer than in past recessions. That may be because they have less incentive to find jobs because Congress has provided very generous long-term unemployment payments. In any event, the pace of firings is down sharply, and real pay per worker for those who are employed is getting a lift from productivity.

(9) ***The Housing Worry***. Housing was the epicenter of the financial crisis. It remains the weakest link in the US economy. It has received lots of support that is about to be withdrawn. The housing tax credit expires in April. The Fed will soon stop buying mortgage-backed securities. The FHA is tightening its lending standards. This could all cause a double-dip in housing activity and drive down home prices again. Then again, why did the Treasury announce on Christmas Eve last year that Fannie and Freddie would be allowed to borrow without limit from the government? This could be Plan B to avert another housing meltdown.

(10) ***The Iran Worry***. The price of oil has been rising in recent days as tensions mount over Iran's nuclear program. I doubt that the Israelis will bomb Iran given the enormous military hurdles of achieving a successful strike. But such an attack can't be ruled out given the existential threat to their nation. An attack might be a setback to Iran's nuclear ambitions, but it would certainly trigger another major conflict in the Middle East that could disrupt oil supplies. It's hard to put a positive spin on this one unless the Bloom Box is a huge success and depresses the price of oil, thus impoverishing Iran. A more plausible scenario is that the Israelis might threaten to use their new drones to drop tactical nukes on Iran's nuclear sites in an effort to force the world to impose crippling sanctions on Iran.

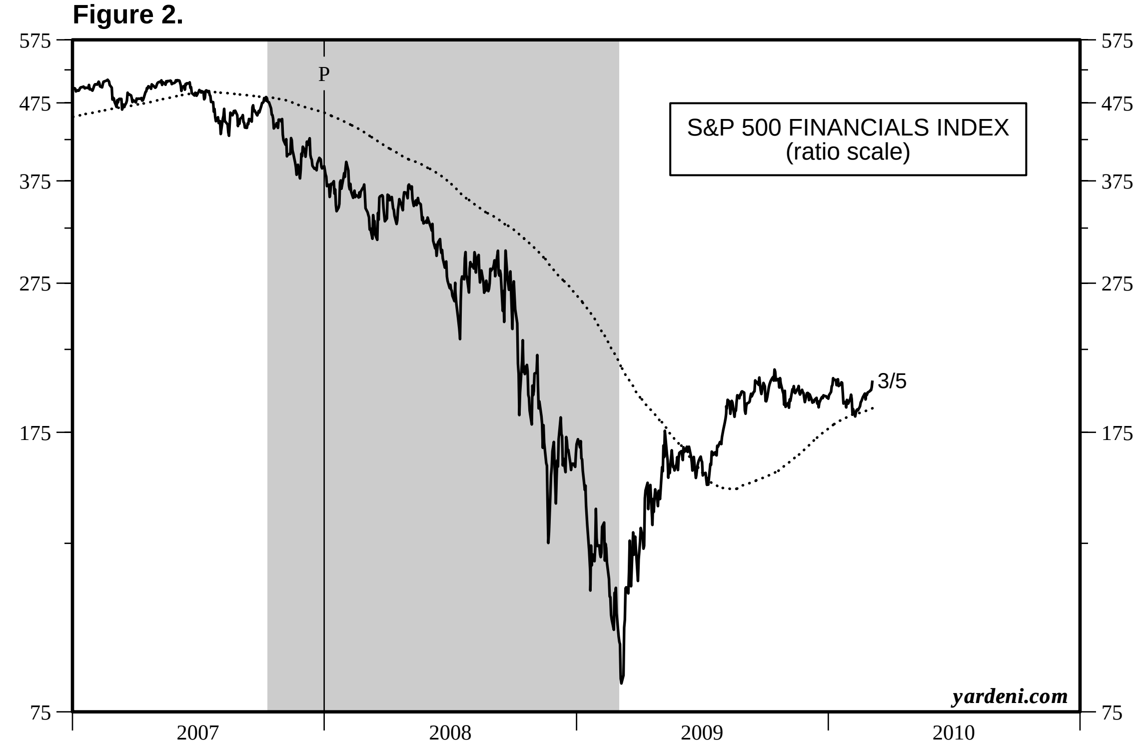
There's a lot to worry about. However, some of the greatest bull markets in stocks occur when the Wall of Worry seems insurmountable.

Figure 1.



* P/T = peaks and troughs of business cycle. Grey shaded areas are bear markets.
Source: Standard & Poor's Corporation.

Figure 2.

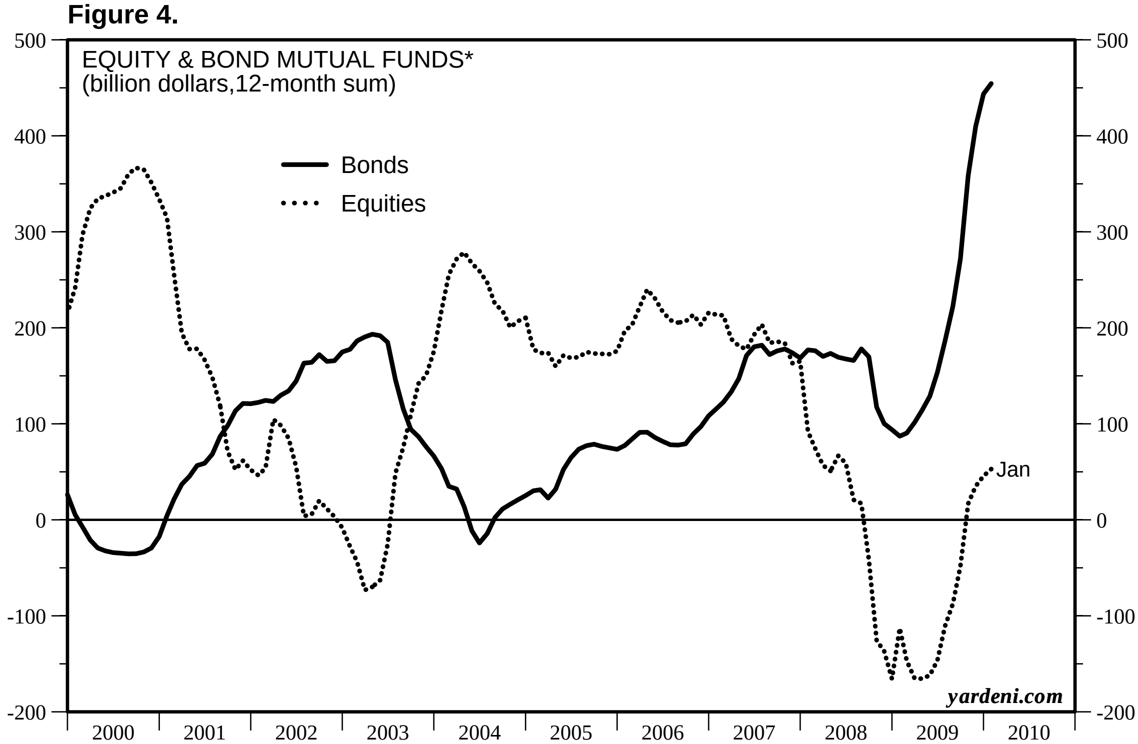


* P/T = peaks and troughs of business cycle. Grey shaded areas are bear markets.
Source: Standard & Poor's Corporation.

Figure 3.

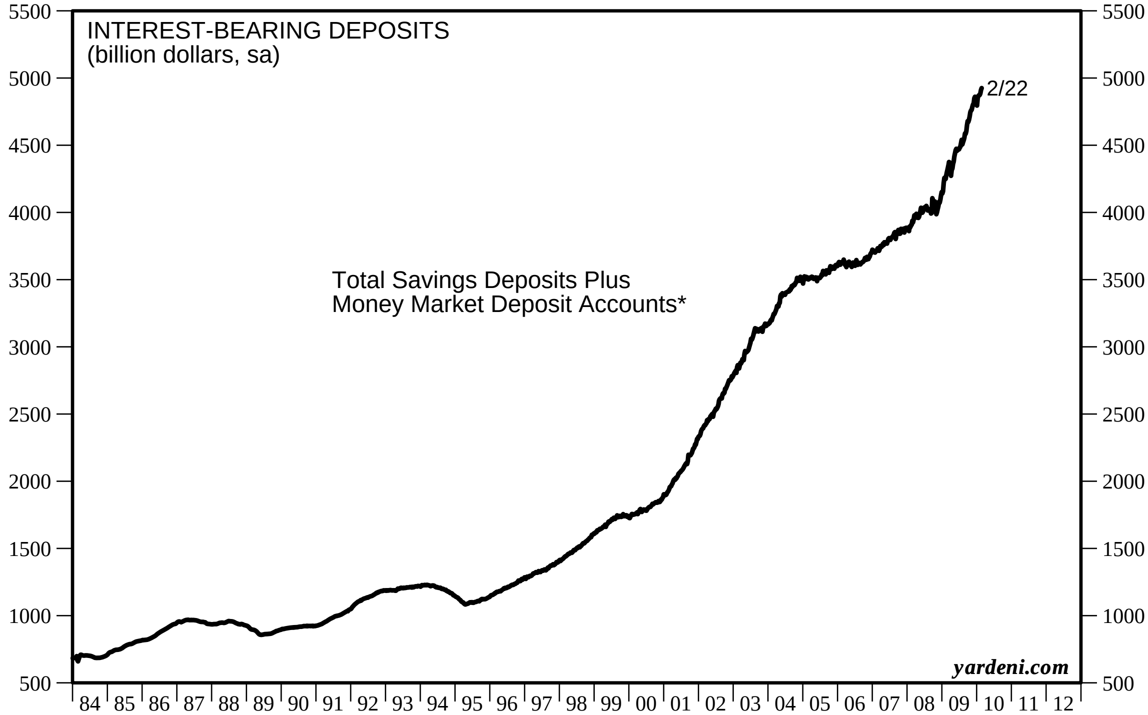
Source: US Treasury.

Figure 4.



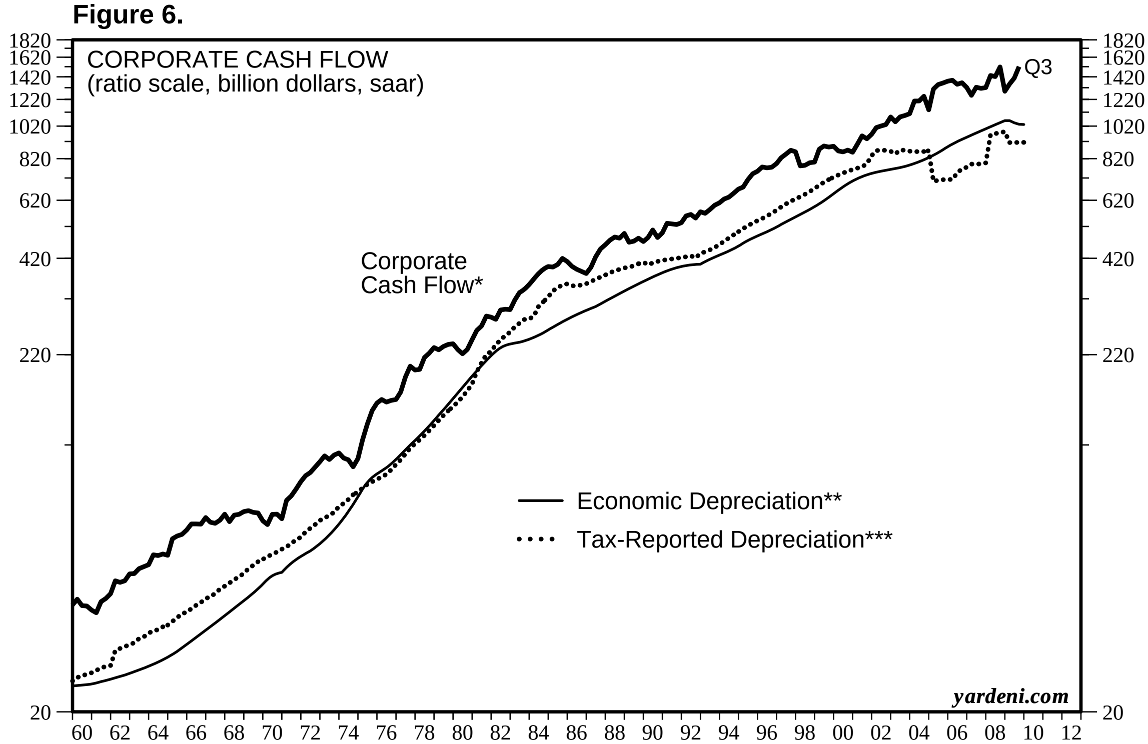
* Figures reflect sales less redemptions, plus the net result of fund switches, plus reinvested dividends.
Source: Investment Company Institute.

Figure 5.



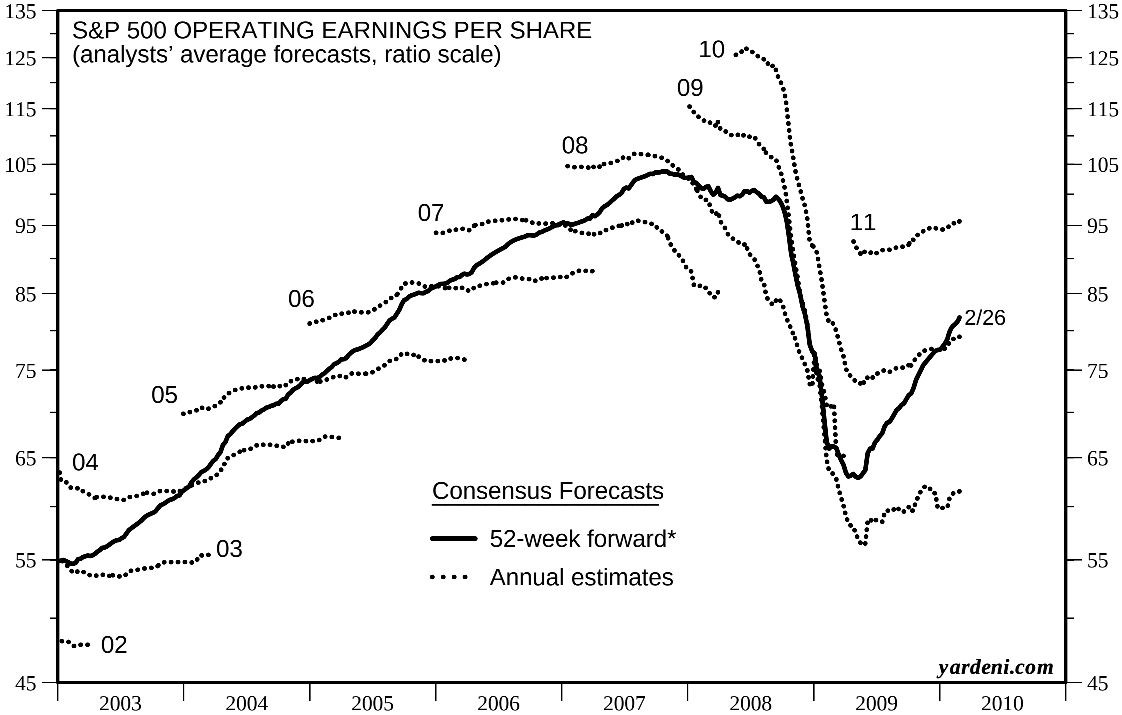
* Included in M2.
Source: Board of Governors of the Federal Reserve System.

Figure 6.



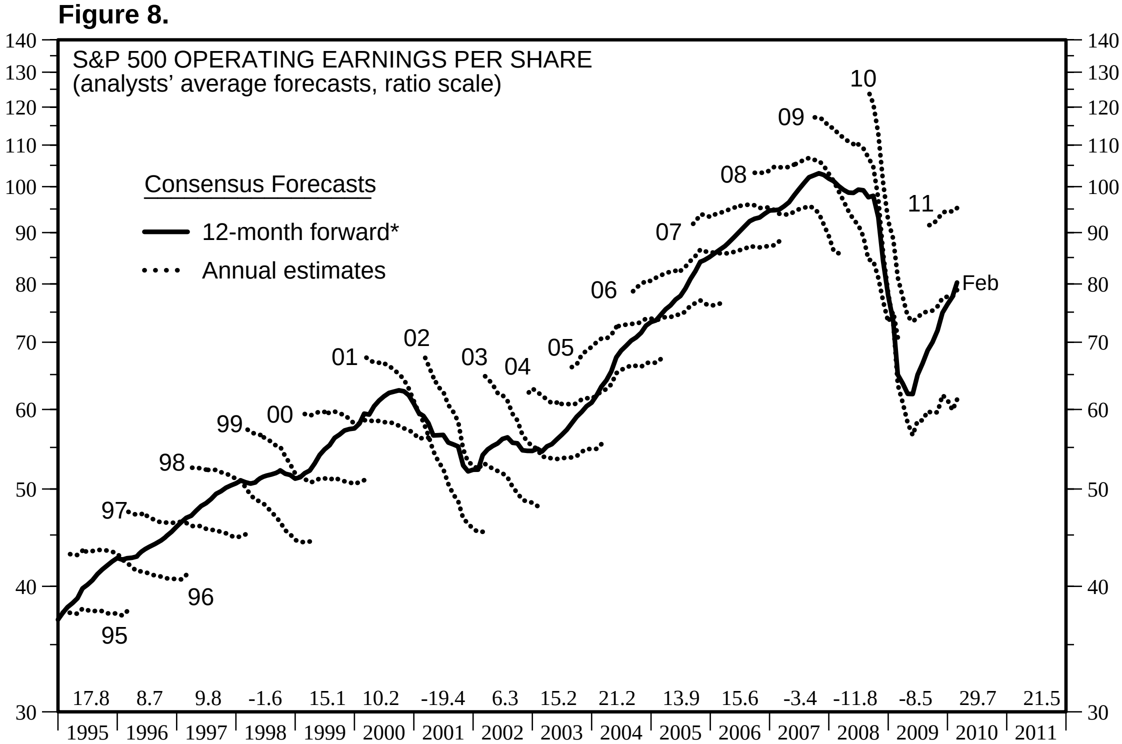
* After-tax retained earnings plus tax-reported depreciation.
** Corporate capital consumption allowances.
*** Corporate capital consumption allowances with capital consumption adjustment.
Source: US Department of Commerce, Bureau of Economic Analysis.

Figure 7.



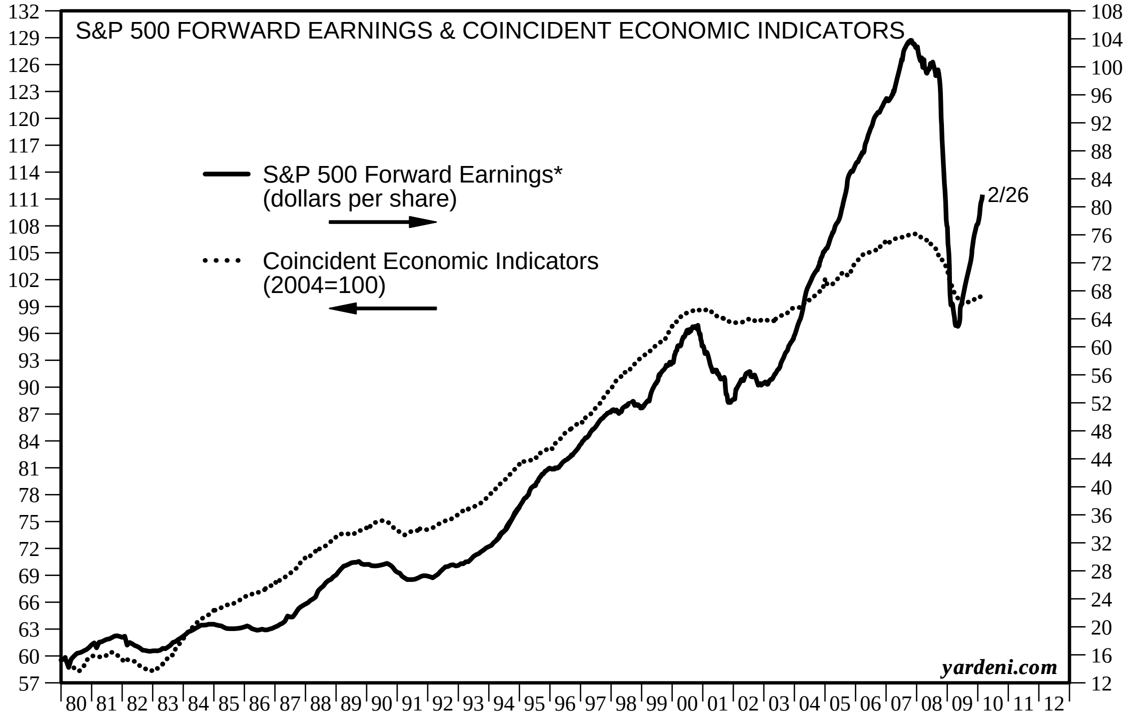
* Time-weighted average of current and next years' consensus earnings estimates.
Source: Thomson Financial.

Figure 8.



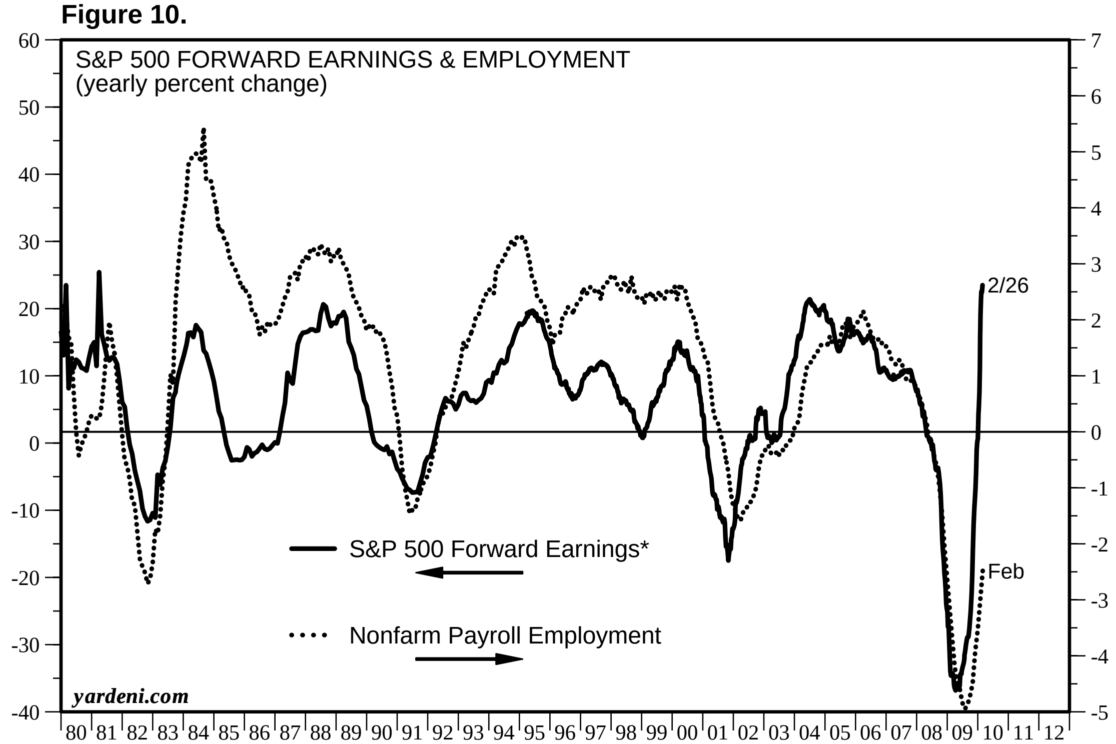
* Time-weighted average of current and next years' consensus earnings estimates. Numbers above time line are annual growth rates.
Source: Thomson Financial and Standard & Poor's.

Figure 9.



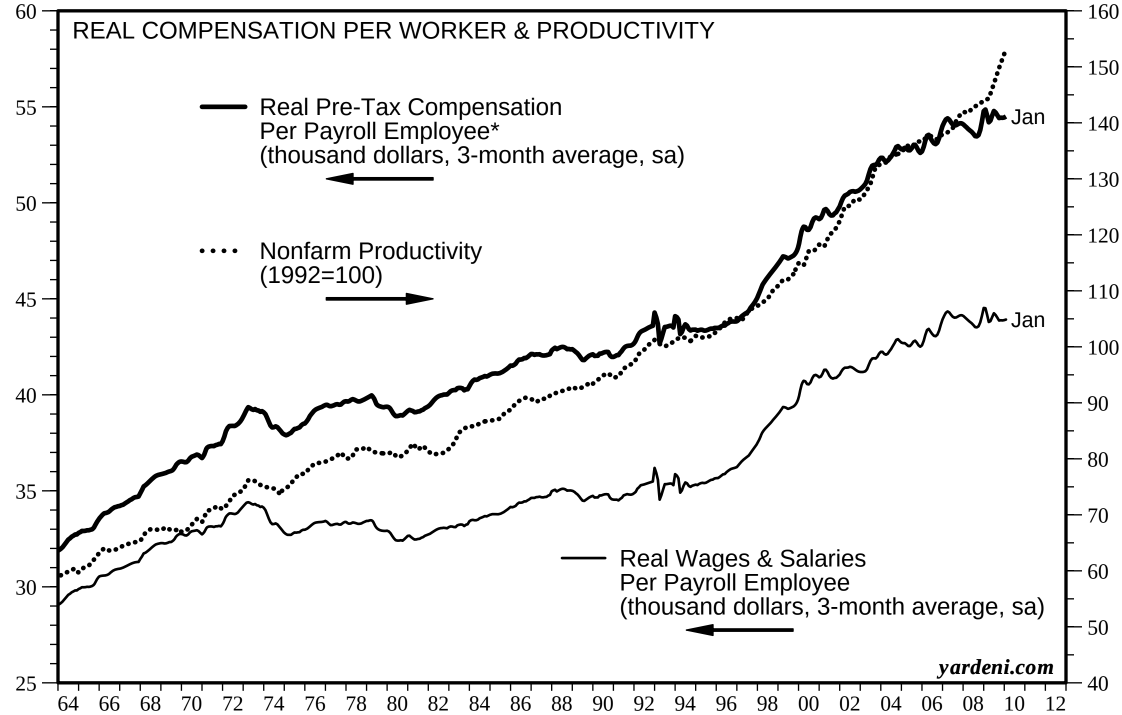
* Time-weighted average of current and next year's consensus earnings estimates. Monthly through 3/94, weekly thereafter.
Source: Conference Board and Thomson Financial.

Figure 10.



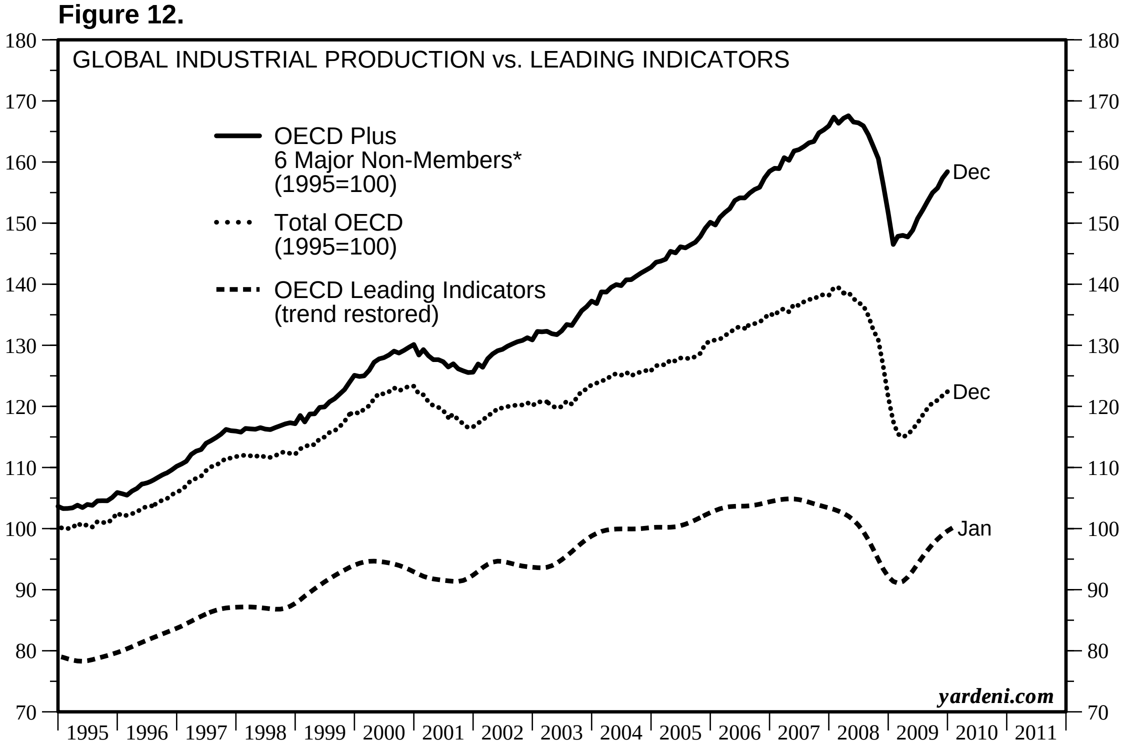
* 52-week forward consensus expected S&P 500 operating earnings per share. Monthly through March 1994, weekly thereafter. Time-weighted average of current and next year's consensus earnings estimates.
Source: Thomson Financial and U.S. Department of Labor, Bureau of Labor Statistics.

Figure 11.



* Three-month average of wages & salaries plus supplements to wages & salaries divided by personal consumption expenditures deflator divided by payroll employment.
Source: US Department of Commerce, Bureau of Economic Analysis, and US Department of Labor, Bureau of Labor Statistics.

Figure 12.



* Includes 30 OECD countries plus Brazil, China, India, Indonesia, Russia, and South Africa.
Source: OECD

Additional Information Available On Request.