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The Recovery is not Over

The year-end rally in stocks that extended into the middle of January ended with one final burst of speculative enthusiasm, with low-priced and low-quality stocks once again leading the way. The ensuing correction was inevitable, given the extremely high levels of bullish sentiment that had persisted over the previous few months. The percentage of bullish advisors, as measured by the Investors Intelligence had been hovering in the high 50's, with the percentage of bears only in the mid-teens. There was a correction in the making, and it finally arrived, set off by Federal Reserve Chairman Greenspan. The market was in such an overbought, speculative position that it took no more than his comment that sometime, someday, the Fed would see fit to raise short term interest rates. With that as an excuse, and with a seasonally weak first quarter to endure, the S&P 500 fell about 7% from its January highs.

With the correction underway, the sentiment numbers shifted significantly. A couple of weak employment reports and a short term oversupply of computer chips in January allowed some folks to utter the dreaded "double dip" phrase. The fear was, if the Fed is going to tighten and the economy is already peaking, we must be heading into another recession. Enough investors were spooked that the Investors Intelligence Survey, which had peaked in February at over 60% bulls, moved to 46% bulls and 25% bears.

Of course, all this fear provided the wall of worry that the market needed in order to climb back toward its January highs. This time, however, the climb was accomplished with a different mix of stocks. Leadership began to shift toward higher quality stocks, a welcome sign for the sustainability of the market rise.

So where are we now after a lot of sound and fury? In the short run, Sentiment can support higher prices. Although bulls at 46% is hardly indicative of a market bottom, these levels are not out of line in the context of a rising market. April and May are often kinder months to the markets than February and March. Thus there's a good chance that the S&P 500 will reach new highs for this cycle during the second quarter, with leadership continuing to shift toward higher quality stocks and away from the lower quality and low priced issues that led the market last year and into early 2004.

Beyond the second quarter, things get a bit cloudy. The Federal Reserve is concerned less with stock prices, than with price stability and employment. Clearly, for the last couple of years they have been concerned about encouraging job creation, and not at all about inflation. Despite all the rhetoric about a jobless recovery, it does appear that jobs are finally turning up. When it becomes clear that this is indeed the case, the Fed will have no choice but to start raising short term interest rates, both to protect the dollar and to react to incipient inflation in commodity prices. Rising short term rates alone do not necessarily imply lower stock prices. Rather it's the shape of the yield curve that is the key. Flat to inverted yield curves (short term rates equal to or higher than long rates) are what kills the economy and the stock market. The curve is so steep now, however, that it could be a long, long time until that much flattening occurs. With the Fed not likely to be much of a factor in the stock market in the intermediate term, the next six months should be okay for stocks.

In the longer run, valuation matters most. Without a doubt, the recovery in earnings in U.S. corporations has been phenomenal. Compared to a year ago, S&P 500 earnings are running up about 50-60%. The price/earnings ratio of the S&P 500 is about 18 times on 2004 earnings and less on next year- not bad for where rates are. Dividend yield is a little low, but larger S&P 500 companies are raising payouts dramatically; e.g., Wal-Mart went up 44%, Pepsico up 44%, etc. Let's call valuation neutral.

So, with no inverted yield curve in sight, rising earnings and dividends, and some money on the sidelines the equity market has room for further upside, with leadership continuing to shift to higher quality.

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