

The rally that everyone loves to hate: Looking at the current stock market performance

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Investors have a love/hate relationship with the current stock market rally that started early October of 2011. Simply put, they love to hate it. The chorus of investment strategists calling for a 5% correction is becoming a scream. The reasons, they give, are straight forward. Below I will cite the top 10 reasons and the counter to each one. Then I will summarize why investors need to look past this and see what really drives stock market performance.

1. The major stock averages haven't had a daily decline yet in 2012 of 1% or more (as of Friday, March 2, 2012. Counter: Stocks are volatile; that's why they are called a "risk asset". The fact that they haven't retreated more than 1%, however, is immaterial. Experienced investors know that stocks often and will retreat more than 1% without warning. Last August, when down days of 5% or more were commonplace, strategists cited that as a bad omen for stocks. Of course, for those who bought in those scary days, the reward has been higher brokerage statement balances. Low or high volatility over short stretches of time is what it is, nothing more.

2. The major averages are up 20%+ from their low of last October. Counter: So what! Stocks early last October were predicated on a systemic collapse of the global financial system. It didn't happen, as witnessed by my writing this. A better point, in my opinion, is that stocks were largely flat last year. If we had a big up move in stocks last year ahead of the current improvement in macroeconomic statistics, I would be much more cynical about this year's rally.

3. The Greek debt deal hasn't solved the European sovereign debt problems. Counter: Correct, but this is a known factor. And since known factors do not drive stock market performance, we should discount this one. The real deal of the 2nd Greek bailout was to buy the Euro-area central governments and banks more time to shore up their financial firewalls. The ECB's LTRO (Long Term Refinancing Operation) policy was the right policy response to placate the Euro-area induced global financial panic.

4. Investors are too optimistic. Counter: I speak with investors all day every day; I do not get the sense by any means that investors are overly optimistic. For the retail investor, fear and loathing is still the order of the day. This current rally has been fueled by institutional investors who have moved money from the sideline into stocks; money that was already inside stock portfolios that was earmarked for future stock additions. According to Trim Tabs Data, as reported on CNBC.com, "Bond funds over the past four weeks have taken in a staggering seven times as much money as equity funds, continuing a pattern that has held steady since the cycle run began." This just doesn't sound like investor optimism to me. But when investor optimism returns in a big way, clients who are invested now should be rewarded for being early.

5. Most individual stocks are trading above technical levels such as their 50 day and 200 day moving averages. Counter: This is what always happens when stocks move to a new high; 4 years

for the Dow, almost 1 year for the S&P, and 12 years for NASDAQ. In rising markets, moving averages move higher too. When I look at the 12 year charts of many large cap companies that I follow, I see stocks that have become washed out; anybody who could've, would've or should've sold them have done so by now. In technical analysis, this removes a lot of upward resistance going forward.

6. Crude oil has gone up in price...a lot...and will pinch the pocketbooks of consumers and businesses.

Counter: This is the best argument put forth by the bears. When consumers get pinched at the pump, they cut back spending in other areas. But, we as a nation are using less oil than a few years ago. Plus, employment is gaining momentum and the banking system is in much better shape than 2008 when oil spiked to 147/brl. Oil plunged to the 30s shortly after that record peak price, by the way. I have not seen or heard of one place on Earth where there is an oil shortage; the world has adequate supply and now America is using less foreign oil as a percentage of total oil consumed. My sense, higher gasoline prices are a headwind, but not a death knell to stocks when employment is improving.

7. Profit margins are peaking. Counter: Not true, but they are decelerating from a very high level of profitability. Corporate America is cash rich and aggregate earnings have actually never been higher. Investors cannot find a time when large cap companies were in better financial shape. Yet, on the aggregate, stocks are in better shape and valued lower than 12 years ago.

8. The Dow Jones Transportation Average is lagging the DJIA (when these two indices are not moving high together, it is considered a signal of a coming downtrend for stocks). Counter: Airlines have not been a good business model and trains are transporting less coal as natural gas becomes a greater feedstock of electric utility output. United Parcel Service had a record year in 2011, led by domestic operations. Cummins Engines reported record sales and earnings for 2011; this is one of the biggest heavy duty truck engine manufacturers in the world. No kick against Dow Theory adherents, but maybe the DJ Transportation Average isn't adequately representing the transportation sector.

9. The potential for an Israeli attack on Iranian nuclear facilities. Counter: Oil will spike; no question. But if history is any guide...and in the world of financial markets, it is very often the best guide...war in the Middle East has typically had only a short term impact on oil prices. Whether war involves the USA directly or indirectly in the Mid-East, oil prices have eventually moved back to pre-crisis levels.

10. China's economy is slowing. Counter: The negatives of a slowdown in China's economy will no doubt be felt by investors the world over, especially since so many large cap companies are global. But the benefit to U.S. investors is that this takes pressure off inflation. Lower commodities inflation would be a boon to corporate earnings while helping the Fed stick to its current accommodative policy. Of course, we don't want China to hard land, but their current target, or a little softer, would be beneficial to stock investors.

Better than just countering the bear's argument, this author is data driven. Interest rates, inflation, asset valuations relative to other assets, corporate profits, and the economy are the true long-term drivers of stock market performance. Psychology is the driver of short-term performance. Consumer confidence just rose to a 1 year high in February (The Conference Board). Jobless claims continue

to drop, reclaiming a 4 year low (Labor Department). The Chicago PMI , which measures business activity in the Midwest , rose to a 10 month high; indicating that its employment component reached its highest level since 1984 (The Institute for Supply Management). The CEO of Toll Brothers, one of the nation's largest publicly traded builders of new homes, said "We're seeing improvement everywhere." Existing home sales recently climbed to a 1 ½ year high, according to The National Association of Realtors. The stocks of the nation's largest home improvement chains, Home Depot and Lowe's, are trading at or near their 52 week highs. The Federal Reserve Bank of Philadelphia reported in its survey of business conditions in the Mid-Atlantic region that manufacturing gains are gaining momentum. Automobile sales are strong and Boeing continues to receive large orders for new aircraft. GDP, while not booming, just came in at a slightly revised higher figure of 3% (Commerce Department). This figure is considered to be consistent with an improving labor market and low inflation, two desirable traits for stocks.

Investors shouldn't be blamed for doubting the wisdom of owning stocks. It was just about a year ago that we seemed to be off to the races with an improving economy and a rising stock market, only to be kicked in the teeth yet again last spring. Well, I would never say it's different this time. I am saying that the data today is better than last year and stocks are at just about the same place.

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