

We're Investigating the Santa Claus Complex... Do You Believe?

By E. Jeffrey Roof

“Four years ago in October 1998, I had written the article, “Yes Virginia, There’s a Downside to the Market”. The purpose was to remind investors that investment decisions should not be driven by irrational market expectations or the misguided belief that market fundamentals are irrelevant because we have entered some ‘new’ era. Eventually, basic principles of economics return to drive the market.

Recent moves in stocks have again demonstrated that the financial markets are influenced by both economic and psychological factors, and not necessarily in that order. After falling for six consecutive weeks due to dismal economic reports and increasingly negative investor sentiment, a broad based market rally at week end was capped with a 316 point rise in the Dow Jones Industrial Average on Friday October 11, the fifteenth largest point gain ever for this index.

Almost immediately, some pundits hinted a ‘market bottom’ had been reached. Frankly, we’re skeptical.

What fueled this euphoric surge? Credit for the market advance is given to General Electric (GE) meeting its muted earnings target for the quarter and a Lehman Brothers upgrade of International Business Machines (IBM) based on the guess that corporate technology spending will rise in 2003.

Both tidbits provided some welcome non-negative news but, when viewed rationally, neither is sufficient to spark the all-out curbs –in rally seen that Friday afternoon. This is particularly true when that same day also brought news of consumer confidence being at a nine year low and retail consumer spending, which has helped the economy limp along thus far, slowed in September.

One theory for the bounce is that after weeks of extensive selling, investors were looking for any sign that possibly indicated a ‘market bottom’. First off, countless studies have shown that guessing a market bottom (or top, for that matter) is a futile effort and that market turnarounds are only truly identified when looking backwards.

Likewise, different stocks, industries and sectors turnaround at different times, so defining an overall market bottom is of very little consequence. But many investors want to believe; call it a Santa Claus complex.

Does this mark the beginning of a rapid economic turnaround? Hardly. Will the stock market continue a broad based rally? Who knows? Though related, the economy and stock market do not move in lockstep. Market technicians like to remind us that the month of October has historically hosted several market bottoms with the months that follow providing relatively strong performance. But it is imprudent to generalize the timing of market movements and many of the economic and market fundamentals are currently looking anything but bright.

For example, while the vast majority of stocks cost less now than what they did at the beginning of the year, many are still not cheap. Why? The fundamental relationship between what a company earns and the price of its

stock is expressed in the price/earnings (P/E) ratio. The higher the P/E ratio, the higher the price of the stock relative to that company's earnings. Currently the average P/E ratio of the Standard and Poor's 500 index is more than twice the level it has been at any other 'market bottom' within the past sixty years. So unless corporate earnings rise soon, which runs contrary to current market forecasts, there may be more near term downward pressure on equity prices.

Likewise, to maintain perspective on the possibility that the October 11th Dow Jones performance is the turning point for a sustainable rally, remember that the third quarter of 2002 had three of the top twenty single day point losses ever. So there is still quite a ways to go to even regain some of the ground recently lost. Add to this with the specter of war with Iraq, ongoing terrorism concerns and the lingering effects of this year's corporate and accounting scandals; and any argument that we are on our way into an extended equity rally gets tougher to make.

However, maintaining diversified equity exposure in a balanced portfolio is a critical part of a long term investment strategy and the reduced prices of some stocks have them looking very attractive, even in a shaky market with a lackluster economy. Which ones? In general, stocks of companies in credible business with solid management, consistent earnings, low debt, 10% appreciation potential, a P/E ratio below 15, and dividend yield exceeding 2%.

Most important, it is critical to remember that long term objectives and tolerance for risk should not determine investment decision making, not short term market

moves. The flipside of the October 1998 story applies today. Economic fundamentals dictate that equities will again provide very attractive long term returns relative to other investments. But it is doubtful the market's performance of a single day will be the signal that a wholesale turnaround has begun.

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