Market Outlook
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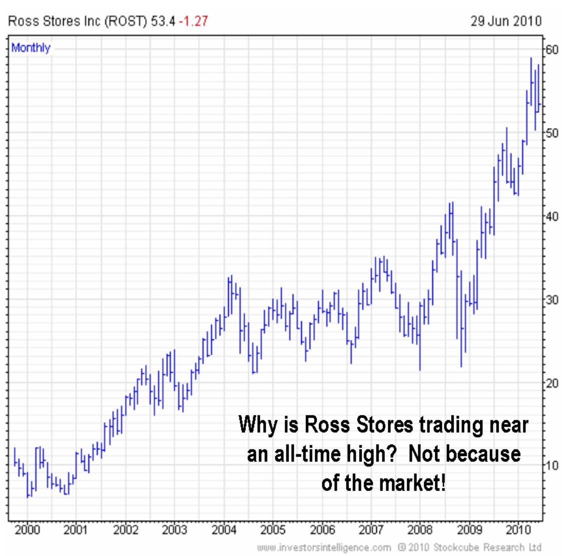
The Molecular Structure of Wall Street

The ever increasing complexity of financial instruments on Wall Street has made it easy to forget one central idea—that there is "molecular structure" to Wall Street. These "molecules" are the individual common stocks and bonds of companies whose products we use every day. Over the past 10 years, Wall Street has manufactured a dizzying array of derivative securities, the workings of which have baffled even some of their creators. By having so many interrelationships the ability to predict the behavior of such a security is subject to considerable margin for error. But by focusing on the molecular structure, an investor has advantages that market-based analysts overlook.



First of all, what is a derivative? A derivative is a security whose value depends on the value of another security for its price. Commonplace derivatives are stock options, which have traded since the early 1970s. The price of the option is affected by both the price of the stock it is written on, and the option's time to expiration. The advent of banking deregulation, profit-hungry investment banks, low borrowing costs, cheap and fast computing power, and the mistaken belief that real estate values never declined combined over the past decade to create a huge array of complex derivative offshoots of this idea, especially mortgage-based products. Of course, as the value of the underlying security was compromised (e.g. 1st mortgage, 2nd mortgage, even the home itself), the ability to value the derivative became harder, and in many cases impossible. Banks overexposed to them saw their capital evaporate as the real estate bubble burst and either fled into the arms of competitors, or faced liquidation in bankruptcy court. With each added layer of complexity, derivatives and other financial "innovations" moved further and further away from the basic building blocks of finance—common stocks and senior-level bonds.

Common stocks, of course, represent an actual share of ownership in an underlying business. They are dependent on the fortunes of the underlying business for their value (along with investor's perceptions about those fortunes via stock market trading). This puts them on a totally different plane than financial "products" many times removed from the "product" a company produces. This is especially important to remember in today's uncertain and volatile times.

Focusing on the molecular structure offers distinct advantages. First, you have a tangible asset. Tangible assets can provide a lot of certainty as we muddle our way through the recession. Whether you walk into a Target store, own a Hewlett-Packard printer, or drive a Honda, as a shareholder the assets and products are plain to see. These companies are almost living, breathing things, with lots of interests vested in their growth and survival. They won't give up without a fight. One of the biggest errors economists make today is assuming corporate (and household) behaviors don't change and adapt to the austere environment we're in. While the stock prices of these companies are certain to fluctuate, sometimes wildly, are the highest quality companies on the NYSE likely to go bankrupt?

At the molecular level, it can readily be seen what is meant by 'high quality.' While GM used to come to people's minds when "Blue Chip" was mentioned, a quick look at its balance sheet revealed that it was swimming in debt, which ultimately caused its demise. Honda, on the other hand, looks sure to survive as an auto company, partly due to conservative financing. Balance sheet analysis is regaining prevalence after years of taking a back seat to Wall Street's worship of earnings growth. As we have seen time and again, a highly leveraged balance sheet can mortally wound a company in a recession, almost regardless of the earnings outlook. I think balance sheet analysis will become more important as we move through the low-growth deleveraging process in the years to come.

While analysts are arguing about the correct earnings forecast for the S&P 500, or its proper price/earnings valuation, a review of the individual building blocks of the index reveal many companies that are recovering from the recession (and plenty that aren't). Moreover, some are seeing vibrant demand for their products either because of new technology (smartphones), basic needs (energy), or simply because things wear out (retail auto part stores). An obsession with market analysis is misplaced, as the molecular view allows one to look through the noise of media headlines and provides a window into the winners and losers in today's challenging business environment. Perusing the Value Line Investment Survey every week has made one thing clear to me —investors have enough low-debt, high return on capital, and growing companies out there to build successful portfolios.

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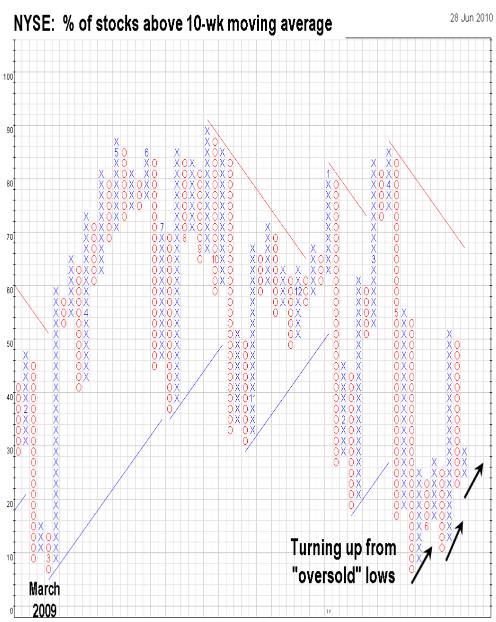
The lesson for investors today is that the closer one stays to the “nucleus” of what your shares or bonds represent (an operating company), the better off you’ll be. The more distance there is between the investor and the assets, the greater the potential for error and disappointment. We have come full circle on Wall Street, from buying only stocks and bonds (1950s), to explosive growth of mutual funds (1980s), to the various complex financial products today. The rise of modern portfolio theory over the past 40 years has brainwashed Wall Street into thinking it’s “the market” that matters. We feel it’s the pieces that matter, and that by focusing on the molecular structure of Wall Street, investors are more likely to successfully rebuild their portfolios in the years ahead.

Stocks: Correction Almost Over?



Stocks have spent the entire second quarter in a corrective decline. Fears over a double-dip recession, the mysterious “flash crash” of May 6, and of course the disastrous Gulf oil spill have all taken their toll on investor optimism. The prospect of a sovereign debt default in Europe and the widening acceptance of severe budget austerity have added to the gloom. This has been the longest correction since the fourth quarter of 2008, and the news media has certainly emphasized the bad news.

But numerous indicators point to the idea that the worst of the correction is over. First, breadth indicators are improving. Stocks above their 10-week moving average (above) have turned up from oversold levels, a typical sign of a price bottom. Longer term measures, such as stocks above their 30-week moving average, have also begun to improve, but their follow-through to the upside is lacking, not a good sign, and as of the closing days of June these measures were close to downturns.

The NYSE advance/decline line gave a sell in May, and then turned around with a buy signal in June. While currently positive, this measure (below) is still being constrained by the descending resistance line. A break above this line would go a long way toward bolstering the bullish outlook, but as with the breadth indicators, this measure remains under pressure as of this writing.

Perhaps less murky in its message is that investor pessimism is on the rise, generally a good contrarian sign. The length of the correction, and the negative news environment, has certainly cemented the grim outlook in the national psyche. High levels of pessimism, though, typically coincide with lows in stock prices, and the waves of selling we have had to endure this quarter show investors voting with their dollars by getting out. Overwhelmingly bearish sentiment is typical of the late stages of market declines, and numerous sentiment surveys show this is becoming widespread. In other words, psychological measures are beginning to reach bullish levels.

A classic example is the June 14th Bloomberg Businessweek magazine cover below, entitled “What We Can Learn from the Endless Pessimism of Wall Street’s Biggest Bears.” While gloom ebbs and flows a little each month, if it continues long enough it may make the cover of a general circulation magazine. These magazines capture the social mood at any given time, but only after the mood has become pervasive. The tendency of extremely bearish covers to mark bottoms (and bullish ones to mark tops) has been well documented by Paul Macrae Montgomery of Universal Economics. Hopefully, this month’s bearish cover is a sign the correction is almost over.