



The numbers game

Sentiment-driven rally likely to run out of steam

May 1, 2009 – If there's any truth to the belief that equity markets generally anticipate broader economic moves by six to eight months, then the powerful rally in equity markets worldwide since the March low should not come as a big surprise to anyone. We've said as much in these comments over the past few months, saying from time to time that a rally off a bear market bottom, when it comes, is likely to be quicker and more powerful than any one expects.

This is precisely what's been happening over the past few weeks, as global stocks posted their strongest monthly advances since 1991. Led by strength in financial stocks, equity investors shrugged off the bankruptcy and de facto nationalization of Chrysler Corp. and the possible bankruptcy of General Motors Corp. in the US, another quarter of deep US economic contraction in the first three months of the year, and the onset of a swine flu scare originating in Mexico.

Stock markets are forward-looking insofar as investors attempt to price future earnings. Given the downward trend in corporate profits for the past year or so, there doesn't seem to be a lot of reason for optimism. First-quarter US gross domestic product shrank for a third consecutive quarter, as output plunged at dramatic 6.1% quarter over quarter annual rate. That was nearly as bad as the -6.3% contraction posted in the final quarter of 2008, and considerably worse than the -4.7% reading expected by consensus estimates.

Despite this, stock markets rallied through to the end of April. It may be that investors began sensing a turnaround in the performance of the monthly ISM purchasing managers index, which has gradually be reversing trend. The index rose to 40.1% in April from 36.3% in March, still well below the 50 mark, which is the threshold between growth and contraction. However the trend has shown a marked improvement since bottoming at a 28-year low of 32.9 last December.

Investors may also have been anticipating the effect that the massive first-quarter decline in business inventories would have on earnings expectations for the balance of the year and going into 2010. Shrinking inventories and evaporating private investment accounted for a large chunk of the first-quarter US GDP contraction (shrinking inventories alone pulled GDP down 2.79%).

The massive drawdown in inventories and a 2.2% uptick in consumer spending for the first three months combined with a jump in the consumer confidence index to a five-month high of 39.2 may have given investors reason to hope for a return to growth in the second half of the year.

Earnings reports through the first quarter have been less horrible than anticipated, as companies have been slashing and hacking at costs for the past year, closing and consolidating operations, emptying warehouses, cutting jobs, and casting a funereal pall over earnings estimates.

This last point is all part of the earnings estimates game that forms the very lifeblood of the stock markets. The “funereal” approach many companies have recently taken to their own earnings estimates is based on the theory that if dearly departed jumps out of the casket, alive and well during the wake, mourners are likely to forget what put him there in the first place.

So far, that particular little ploy has seemed to work wonders, so to speak, as 188 of the S&P 500 Composite that have reported first-quarter earnings so far have beaten analysts’ estimates. Is it all just a “numbers game”? After all, while share prices were piling on week after week of gains, overall earnings for the S&P 500 still fell 35% in the first three months, coming in just slightly better than estimates of a 37% decline.

Investors may have taken heart from the US Federal Reserve Board’s decision to keep the federal funds rate unchanged at its near-zero level. The Fed noted that the “pace of contraction appears to be somewhat lower” and that household spending may be stabilizing. The 10-year US Treasury note ended April with a 3.124% yield, its highest since last November, raising some concern about the selloff in Treasuries, given that the US dollar has remained weak.

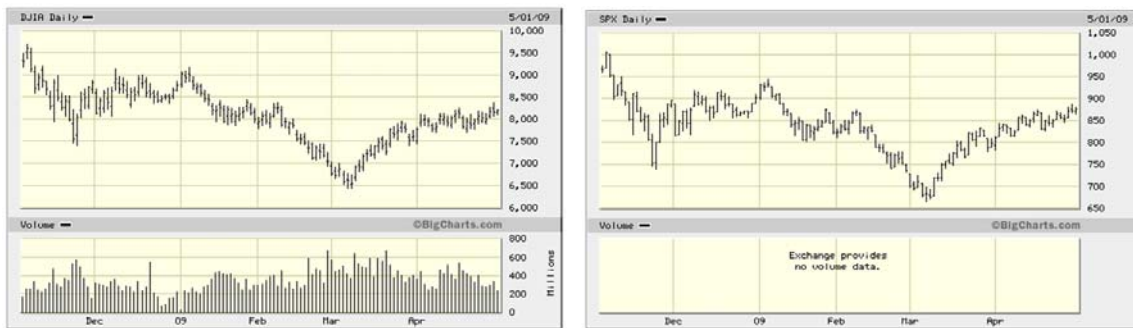
Canadian real GDP shrank again in February, by 0.1% from the previous month, for a 2.3% year over year decline, and the seventh consecutive monthly retreat. The overall picture for Canada’s economic health does not look good for the first quarter, as manufacturing remains down 11% year over year, weighed down by the rapidly disappearing domestic automotive sector. Canadian inventory levels remained high, and unemployment rose in March.

Still, the S&P/TSX Composite Index advanced 6.9% month-over-month in April, for a year-to-date gain of 3.8%. However, the index failed to post another weekly gain, closing last week down 0.6%. The S&P/TSX has advanced 27% from its March low.



The Dow Jones Industrial Average ended April with a 7.4% month-over-month gain, but remained 6.9% in the red year to date. The DJIA closed last week with a weekly gain of 1.7% in advance of next week’s release of the “stress test” results for the nation’s largest banks. The DJIA is up 32% from its March low.

The S&P 500 Composite Index rose 9.4% in April, its best performance for April since 1938. The S&P 500 was still down 3.4% year to date. However, it advanced 1.3% on the week as of last Friday’s close, and is now up 32% from its March low.



Such a powerful advance off a bear market low starts to look very much like a sentiment driven rally. The numbers, especially the numbers from the earnings game, aren’t likely to support such a rally for too much longer. ■

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