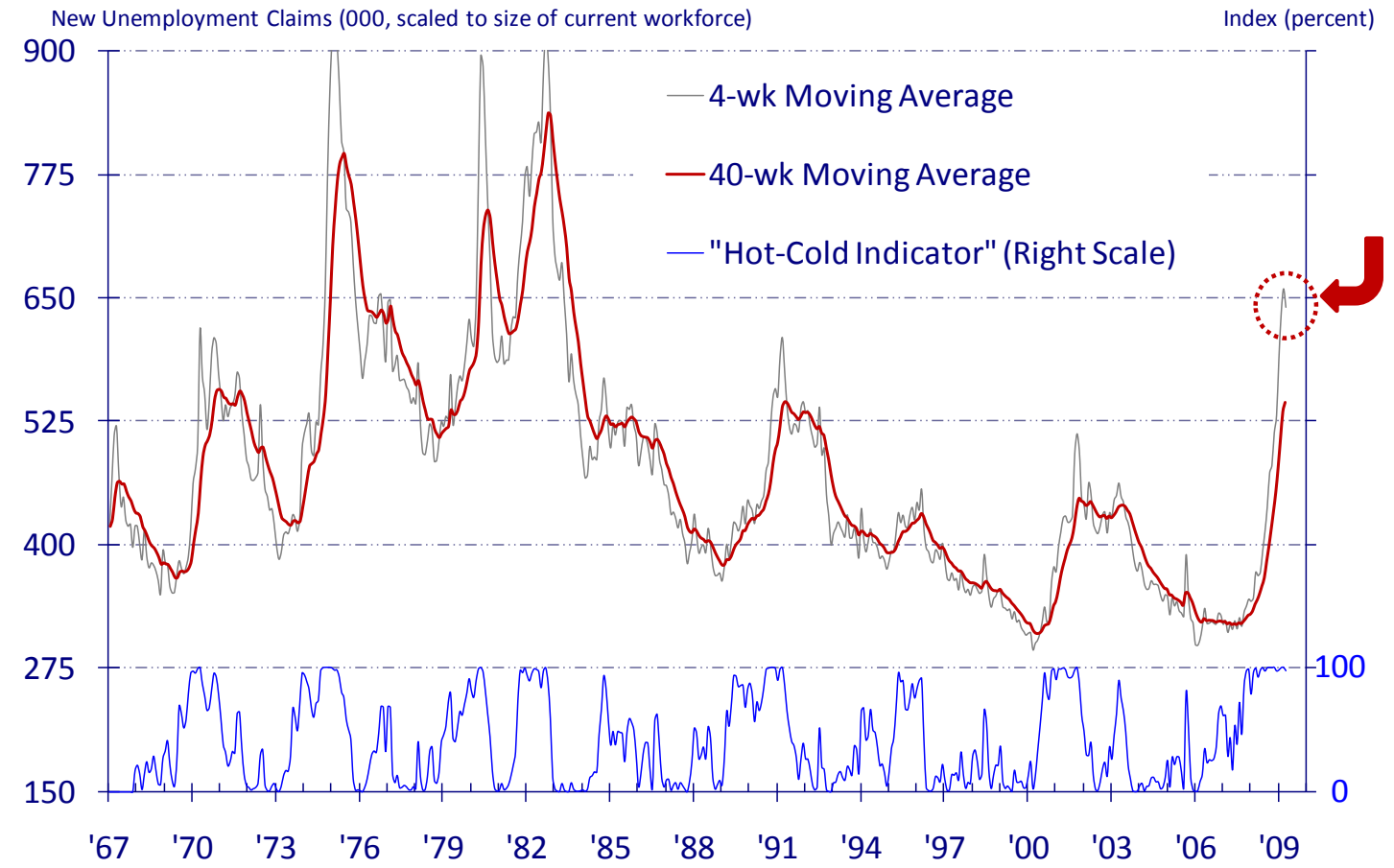


Report Card Changes: Sentiment & Valuation Both Decline to “B” From “A”

- The market's move up from the early March lows is impressive only when compared to the steep losses suffered in the first two months of the year. After all, only the Nasdaq and the Value Line indexes are in positive territory for 2009, amidst eight other so-called “Major Indexes” shown in the weekly wrap-up of *The New York Times*.
- Last week, we showed how a growth orientation and heavy weighting in technology and health care stocks was behind the Nasdaq's performance — many of these companies had fallen less when the market was lower and were maintaining their leadership even after the 6 week run-up.
- But the strong performance of the Value Line index is a different phenomenon, and represents a significant shift in sentiment that demands our close attention. Last week, we noted that “some areas where investors sustained the most damage over the past 2 years have enjoyed very sharp rebounds [but] this “performance” can be misleading when measured in percentage terms from depressed levels steep rallies for beaten-up issues have stirred bullish sentiment [for] ‘economic recovery beneficiaries,’ such as retailers and other companies sensitive to trends in discretionary consumer spending.”
- The Value Line Composite index is comprised of 1700 stocks that form the core of the company's research offering. Large, mid and small capitalization companies are included in the index, which is equal-weighted. From mid-July 2007 to March 9 this year, the index dropped over -60%. Since March 9, the index is up +54%, so now, the index is up +10% in 2009 and the cumulative loss from the bull market peak in 2007 has been cut to -40%.
- Earnings and dividend growth turned negative for the Value Line Composite a year ago and continue in a downward trend, while reports on the economy are not improving, merely getting worse at a slower pace. One example is the trend for new unemployment insurance claims (see chart), which are still very high, but may have reached a peak earlier this month. Suddenly, economists are echoing a more optimistic message from central bankers and other policymakers, who see “green shoots” jutting up from the barren landscape.
- It was nearly five decades ago that Eugene Fama of the University of Chicago developed the idea that markets “efficiently” incorporate all known information about company prospects and the economic environment. In our view, markets may be mostly efficient, but negative investor sentiment often causes an overshoot to the downside, while a rapid mood shift toward optimism can do the same on the upside — as we have just seen.
- Several months ago, we put forth our “Market Report Card,” grading the investment environment on four major subject areas: the ECONOMY, VALUATION, LIQUIDITY, and SENTIMENT. Given the significant mood shift that has occurred, we now rate the SENTIMENT score as “B,” down from “A.” “B” is still better than average, but shows that fear has dissipated and optimism has returned. We sense that investors are far from being complacent, which would warrant a “C,” and even farther from a euphoric state, where a “D” would be appropriate.
- Furthermore, the sharp move up for the Value Line Composite index in the face of continued economic deterioration means that equity VALUATION is somewhat less supportive than during the winter. We now rate VALUATION as “B,” down from “A.” As noted above, “B” is still better than average, but the median P/E is now over 14x, and the median dividend yield is now under 3%, both for the first time since October. By comparison, at the market highs in 2007, the P/E was 20x and the dividend yield was 1.6%. The other 2 subjects on our report card — ECONOMY and LIQUIDITY — both retain their prior grades of “D.”

New Claims for Unemployment Insurance Appear to Have Reached a Peak

(N.B. Our chart adjusts the historical claims data for the increase in the nation's workforce over time)



Note: Historical initial unemployment claims are scaled higher to reflect the significant increase in the size of the labor force over time. 4 and 40-week averages are shown to enhance clarity. The indicator at the bottom of the chart reflects the current level of initial claims as a percentage of the trailing 12-month high and low. If the current level of claims is at a 12-month high (low), the indicator will show 100 (0). Source: Department of Labor.

The chart shows the sharp increase in new claims for unemployment insurance since the start of the recession in 2007. Even though recent peak readings near 650,000 are the highest on record, the statistics are not really comparable to prior recessions because of population and labor force growth. We have adjusted the historical data to make the comparisons more relevant, and constructed a "hot-cold indicator" to illustrate the short term swings in the labor market.

Some economists have become more optimistic now that new unemployment claims appear to have finally topped out (see arrow and dotted circle). In the past (1974, 1980 etc), a peak in new claims has coincided with major market lows. But the relationship is hardly perfect: in the last recession, a surge of unemployment claims after "9/11" caused the peak to occur long before the market's ultimate low in March 2003.

Tom McManus

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