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Investment Strategy

# Me, Lord Marlboro, and the Dow!?

> "An American race horse owner, while parading his entry in the paddock just before the event, fed the horse what appeared to be a white tablet. Noticed and challenged by an English track official, Lord Marlboro, the American was informed that his horse would have to be disqualified. Protesting vehemently that he only gave the horse a sugar cube, the owner popped one into his mouth and offered Lord Marlboro a cube as proof. The English official tasted and swallowed the cube. He agreed with the owner that it was a harmless sugar cube and waived the disqualification. Just before the race horse was to enter the gate, the American signaled his jockey, instructing him to keep his horse clear of trouble near the start and try for the lead early since his horse was sure to win. 'In fact,' he told the jockey, 'Only two have a chance to beat our horse.' 'What two?' asked the jockey? The American owner replied . . . 'Me and Lord Marlboro!'"
>
> *. . . Anonymous*

I recalled the "Me and Lord Marlboro" quip as I watched the running of the Kentucky Derby over the weekend. Evidently, someone fed Super Saver the proverbial "sugar cube" as he won the race by crossing the finish line two and a half lengths ahead of the fast-closing Ice Box. Likewise, someone must have fed the Dow Jones Industrial Average (DJIA/11008.61) a similar "sugar cube" nine weeks ago, as the major averages "galloped" from their February 25th low into a "buying stampede" that has confounded most with its ebullience, including me. Indeed, the stampede is now legend at 44 sessions without anything more than a one- to three-session pause/correction. Surprisingly, however, despite all the snorting, cheerleading, and animal spirits, the DJIA is only about 60 points higher than it was when I turned cautious (but not bearish) in March. And that, ladies and gentlemen, is like it should be, for history shows that if a stampede is able to extend for more than the typical 17 to 25 sessions the "momentum peak" tends to come between the 25th and 30th session because it is rare for a stampede to last for more than 30 sessions. In this case, it appears the momentum peak came on March 26th at DJIA 10955.

Consequently, I have counseled for caution over the past five weeks, and despite my renewed "hate mail" (for being too soon'ly cautious), I don't think a whole lot of money has been made since that March 26th momentum peak. So why have the equity markets been this resilient? As my friends at the must have GaveKal service note:

1) *Today, the leverage on financial markets is nowhere near what it used to be in 2007 and 2008. Shell-shocked by what happened in 2008, investment banks are no longer large market participants, hedge funds are not running the kind of gross exposure they used to, etc. This means that contagion effects are far more muted and that, consequently, the market is back to pricing risk efficiently.*

2) *For all the talk about the "New Normal," the U.S. economy is recovering very fast. Indeed, if the "New Normal" includes a Richmond Fed survey at an all-time high, a manufacturing ISM nearing 60 and U.S. leading indicators back to all-time highs, etc., we will gladly welcome this "New Normal." The fact that the U.S. economy is picking up speed is good news for the global economy, and for global stock markets.*

3) *Back in September, we wrote a piece entitled A V-Shaped Recovery in Profits, where we argued that the ground was laid for a spectacular rebound in U.S. corporate profits. And every day that passes brings confirmation that this is now an undeniable trend: in Q4, U.S. corporate profits jumped by +30% YoY, the fastest growth since 1983. Better yet, given what we have seen so far in this earnings season, this trend is likely to continue.*

4) *With what is currently happening in Europe, investors are increasingly shifting their bond holdings from the weaker sovereigns to safer hands. In turn, this will mean lower long bond yields in the U.S., Germany, Japan, Sweden, etc. Because stocks are, at their core, an earnings stream discounted by an interest rate, lower bond yields should help to prop up stock prices. Moreover, the Greek Crisis entails central banks that will want to err on the side of caution and likely maintain low interest rates for longer.*

5) *However, leaving aside cyclical factors, there is also another structural force which might help explain the unfolding equity bull market; we are no longer mis-allocating capital like we used to! Maybe the fact that Americans are no longer wasting*

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*money building empty condos in Florida and Arizona should, when all is said and done, be seen as good news and one of the drivers of the current equity bull market? And if the collapse of Greece means that politicians will no longer get away with running massive budget deficits for years on end, then, although what is currently going on in Europe is painful today, we may just be laying the grounds for an epic bull market in the years ahead.*

I agree with the good folks at GaveKal and have repeatedly stated, "While I am cautious, I am not bearish!" That said, after being on a "buy signal" for 11 weeks our short-term trading indicator flipped to a "sell signal" last week. Leading up to that "sell signal" has been what a technical analyst would term numerous "distribution days." A distribution day occurs when a major average declines by at least 0.2% on higher volume than the previous session, suggesting large-scale liquidation by institutional investors. The first such day was April 16th, while the second occurred on April 27th. Interestingly, both of those sessions were also 90% Downside Days. A 90% Downside Day occurs when both the declining volume, and the number of downside points, equal or exceed 90% of the total volume and the total number of points. And, while last Friday (-158 DJIA) failed to qualify as a 90% Downside Day, it did indeed qualify as another distribution day. Moreover, the short-term stochastic, the NYSE 10-day Advance-Decline moving average, the Put/Call Ratio, and the NYSE Trin gauge are also all on "sell signals." Finally, during the week of April 12th the Volatility Index (VIX/22.05) tagged 15.23 for its lowest reading since July 2007. Therefore, if the DJIA falls below its 10,965 – 10,975 support zone the odds of a near-term "top" increase.

Longer-term, however, I remain steadfastly bullish driven by the continuing belief we are in a profit-recovery cycle whereby profits explode, which in turn drives a inventory rebuild and capital expenditure cycle, and then comes hiring and consumption. Clearly, corporate profits have exploded with more than 70% of the reporting companies beating both EPS and revenue estimates (1Q10). Accordingly, inventories are seeing their biggest increases in five years; and, capital expenditures are picking up in many sectors, begging the question, "When are hiring and consumption going to pick up?" My guess is it will be in the fourth quarter of 2010. Nevertheless, I remain cautious in the near-term and would offer the following tactical advice.

If you followed our recommendation to invest in distressed debt 18 months ago, now may be the time to harvest some of those gains and rebalance portfolios. If you have been waiting on the sidelines, however, in the anticipated correction should be the time to buy high quality equities. Further, if you were lucky enough to be invested in small capitalization equities, this may be the time to rotate into large cap equities. One name for your consideration is Strong Buy-rated Noble (NE/$39.49), which has lost roughly 11% from its recent high due to the oil slick in the Gulf of Mexico. Nobel provides offshore contract drilling services for the oil and gas industry. Currently the company has more cash on its balance sheet than ever, it moved its headquarters to Switzerland, giving it an extremely low tax rate, and the shares are trading at roughly 6x earnings and 5x cash flow.

**The call for this week**: In addition to our investment account recommendation to buy Nobel, whose shares have been pressured lower because of the Gulf of Mexico oil slick, you also might consider Archer Daniels' (ADM/$27.94) 7.8%-yielding convertible preferred shares. Fish meal prices tagged new highs last week on worries that same oil slick will reduce supply. The major use of fish meal is as a high-protein supplement in agricultural feed. Unsurprisingly, soybean meal is a logical substitution for fish meal. Currently, ADM shares trade at 10x this year's EPS estimate, 1.3x book value, and are followed by our research affiliate. As for trading accounts, we still like the idea of betting on a pickup in volatility. Granted, our recommendation of buying the iPath S&P 500 VIX Short-Term Futures Index (VXX/$21.21) did not track as it should given the Volatility Index's (VIX/22.05) 30% leap. Another vehicle that may track the VIX better is the iPath S&P 500 Mid-Term Futures ETN (VXZ/$72.17). Also of note is that gold made new cycle highs last week against the Japanese Yen, the Swiss Franc, the British Pound, and the German D-mark; and, we remain bullish.

P.S. – "Literature was formerly an art and finance a trade; today it is the reverse" . . . Joseph Roux in 1770.

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