

# Out of the Blocks



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## Worth Noting

- In the short term, equity markets will remain volatile and quite speculative. Our outlook for investors with multi-year time horizons, however, is unchanged. We believe that investors willing to accumulate shares with cyclical earnings streams over the next six to 12 months will be rewarded over the next 3+ years.
- A small number of companies will report third quarter results this week, kicking off what is likely to be a disappointing earnings season overall. Our projection has been for S&P 500 earnings to be down 5%-6% in the third quarter but that may be too optimistic.
- We were disappointed (but not surprised) that the European Central Bank did not cut its target lending rate last week. Despite the ECB's tough talk on inflation, we expect a Eurozone rate cut as well as rate cuts from the Bank of England in the near term. A coordinated rate cut between the U.S. Federal Reserve and these two central banks is not out of the question. Expect other central banks around the world to follow suit.

## Gauging Current Investor Sentiment

Over the last six months or so, we have written about using sentiment indicators to gauge near term market direction on a number of occasions. Given the extreme volatility of the stock market in recent weeks, we thought a review of the CBOE (Chicago Board Option Exchange) Total Put-to-Call Ratio would be in order.

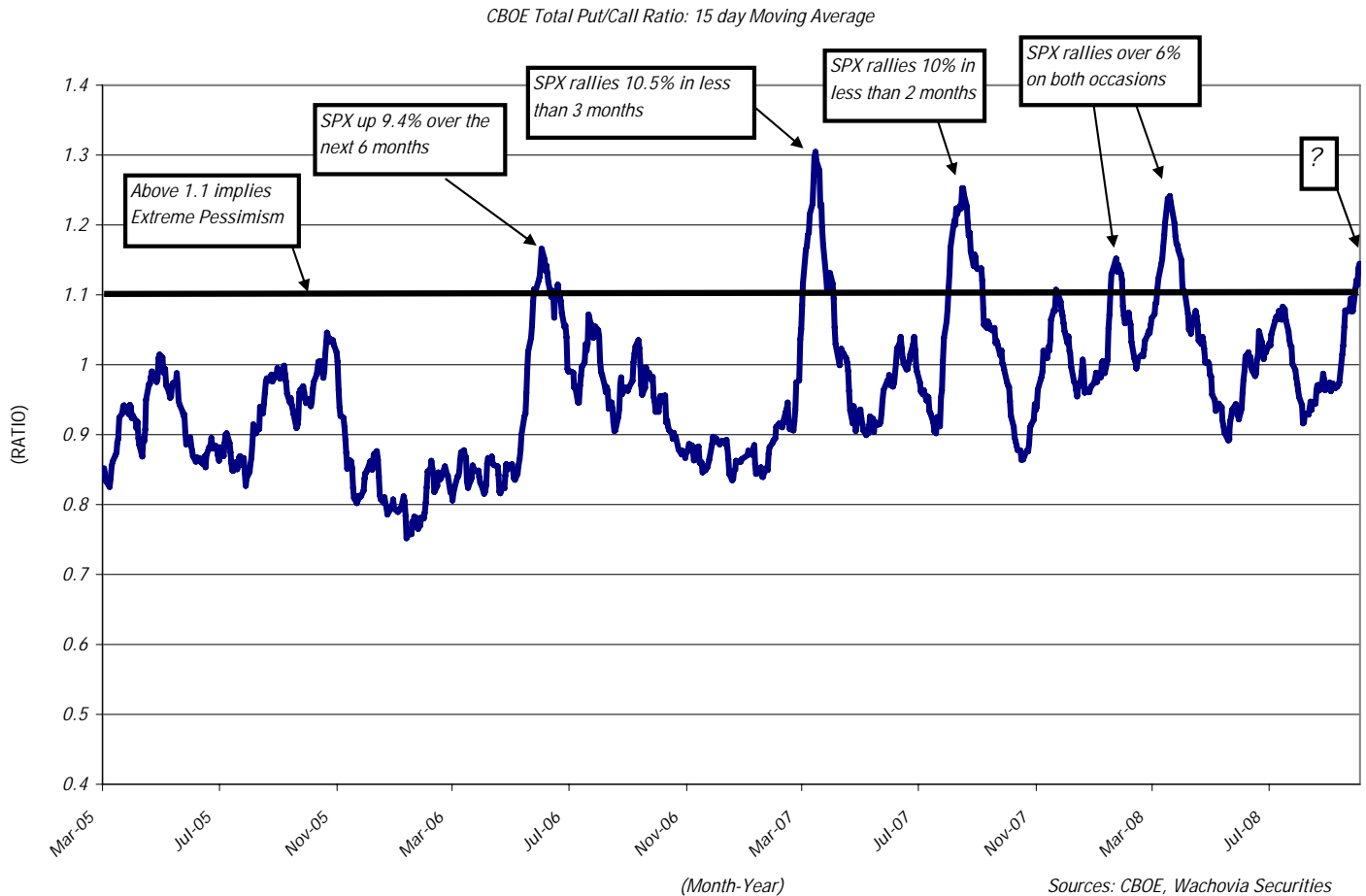
One of the best ways to get a feel for market sentiment is to examine the CBOE's Total Put-to-Call ratio. On a daily basis, the ratio is calculated by taking the total number of puts traded on the CBOE and dividing that number by the total number of calls traded. The owner of a put option has the right to sell a stock or stock index at a set price (the strike price) within a specific period of time. Purchasers of puts typically believe the price of the stock or stock index will decline and are seeking to protect a long position in the underlying stock or stock index or to simply profit from the anticipated price decline. The owner of a call has the right to buy a stock or stock index at the strike price within a specific period of time. A call purchaser would typically believe the price of the underlying stock or stock index is going to rise. When attempting to gauge investor sentiment, we find looking at the 15 day moving average of this ratio to be helpful, particularly when sentiment (fear) reaches overly pessimistic levels. Based on the October 3 close, the 15 day moving average of this ratio currently stands at 1.15.

Our data from the CBOE goes back to September of 1995. Through last Friday, the 15 day moving average has been above the 1.1 level on only five previous occasions (all since June 2006). The 1.1 level indicates that investors are in a heightened state of fear over what lies ahead for equities and have bought puts to protect positions or profit from an anticipated decline. When this indicator reaches such an extreme level it can be a reliable contrarian indicator. In other words, when an overwhelming majority of investors are positioned for a strong downside move in the stock market, it frequently does not happen or the bulk of the downside move has already occurred. Supporting this claim is the fact that each time the 15 day moving average of the put-to-call ratio peaked over the 1.1 level, the S&P 500 index moved noticeably higher over the next several months. The closing level of this ratio on October 3 was above 1.1 but below the highs seen in the previous five occurrences.

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Based on this one particular indicator, it seems likely the stock market, while in a heightened state of fear, is very close to but probably not yet at its absolute bottom.

In the short term, equity markets will remain volatile and quite speculative. Our outlook for investors with multi-year time horizons, however, is unchanged. We believe that investors willing to accumulate shares with cyclical earnings streams over the next six to 12 months will be rewarded over the next three-plus years.

**Specific Recommendations:**

The Materials sector makes up just 3.2% of the total market capitalization of the S&P 500. This sector's index has fallen 30.4% over the last 12 months versus a 28.6% decline in the S&P 500. While we are currently recommending that clients carry an underweight position in the Materials sector, there are a number of companies that appear attractive to some of our correspondent research providers at current levels. "Buy" rated Materials sector stocks among our correspondent research providers total 118 companies. The companies listed below are currently "Buy" rated by at least three correspondent research providers:

- Air Products & Chemicals Inc. (APD-NYSE-\$61.00)
- Newmont Mining Corp. (NEM-NYSE-\$36.00)
- Nucor Corp. (NUE-NYSE-\$32.30)

**Weekly Wrap and Look Ahead**

All three major indices lost substantial ground for the second consecutive week. The S&P 500 tumbled 9.4% (Year-to-date down 25.1%), the Dow Industrials lost 7.3% (YTD down 22.2%) and the NASDAQ Composite dropped 10.8% (YTD down 26.6%). Four of 10 S&P sectors outperformed the Index but all 10 finished lower on the week. The sectors with the smallest losses were Consumer Staples (down 2.3%), Health Care (down 4.4%) and Telecom Services (down 6.2%). The worst performers were Materials (down 14.9%), Energy (down 13.0%) and Industrials (down 12.3%).

A small number of companies will report third quarter results this week, kicking off what is likely to be a disappointing earnings season overall. Our projection has been for S&P 500 earnings to be down 5%-6% in the third quarter but that may be too optimistic. The main wildcard will once again be the Financial sector. It appears Financial sector earnings will be down 70%-80% from the year-ago period but there is a high degree of guesswork involved in making this projection. Note that earnings were down nearly 91% for this sector in the second quarter of this year. Write-downs of mortgage related securities will be substantial in the third quarter.

Last week's economic data was disappointing overall. August and September were poor months for the U.S. economy. What had appeared to be a slow deterioration in overall economic conditions picked up speed over the last couple of months as credit market conditions became more difficult. September payroll data continued to show a weak employment environment as the U.S. lost 159,000 jobs, the ninth consecutive drop. The unemployment rate stayed steady at 6.1% but certainly appears poised to work higher in coming months. The unemployment rate is currently only a bit above the long term U.S. average of 5.6%. Wednesday's ISM (Institute for Supply Management) survey came in at 43.5%, well below analyst estimates. Recessions are often associated with readings in the low 40s for this indicator. Friday's ISM services survey came in at 50.2%, better than most economists were looking for and slightly above the neutral activity reading of 50%. In addition, factory orders fell more than expected in August. Commodity prices continued to plunge last week as the focus has turned toward slowing global growth and away from inflationary fears. The CRB (Commodity Research Bureau) index has fallen nearly 31% from its early July record high. Crude oil is down by more than 35% over the last three months while copper (our favorite gauge of global industrial activity) is off 32%.

This week's economic calendar is only sparsely populated. In addition to the usual Thursday reporting of the initial jobless claims data, minutes from the September FOMC (Federal Open Market Committee) meeting will be released on Tuesday. We expect Inflation fears at the Fed to be quickly fading. A rate cut by the Fed would not be a surprise at the October 28/29 meeting although we would argue that the Fed Funds target is already low enough. The problem is not that the target rate is too high. The problem is that lenders are hesitant to loan money. The commercial paper market is drying up. LIBOR indicates that banks are afraid to lend to other banks. We were disappointed (but not surprised) that the ECB (European Central Bank) did not cut its target rate last week. Despite the ECB's tough talk on inflation, we expect a Eurozone rate cut as well as rate cuts from the Bank of England in the near term. A coordinated rate cut between these three central banks is not out of the question. Expect other central banks around the world to follow suit.

Last week's successful passage of the "rescue" legislation is clearly not a cure all for the market's woes. We look at this legislation as one important step in the process of attempting to normalize the credit markets. This bill will probably take a number of weeks to implement and the benefits will be felt over a period of months, not days. Markets are, in their most basic forms, price discovery mechanisms. Pricing for many mortgage backed securities have been either nonexistent or extremely hard to determine. The legislation also does not seem to address the root of the problem: that giving mortgage loans to people who don't have any "skin in the game" is a bad idea.

The markets will continue to extremely volatile. Pessimism is at extremes. While we believe the economy will be performing below trend at least through 2009, there will be (and are) opportunities for those investors with multi-year time horizons.

**Additional Information Is Available Upon Request. Past performance is no guarantee of future results.**

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