



The Positive Side of Negativity

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Market Commentary

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Put/call ratios are approaching the levels that always create buying opportunities.

Smaller stocks will fare better than big-caps if the economy softens.

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Until last month, the market moved higher in spite of a very large number of negative factors. These last few weeks, however, have seen 25% corrections in many stocks. The now very unpopular war in Iraq has pushed the U.S. budget deficit to record levels. High oil prices are a year old -- a trip to the pump in a larger vehicle can set us back \$50 or more, even if it's not a Hummer. Interest rates have been rising and rising and rising. Last year the economy shrugged off these and other negatives, but suddenly they have become a cause for alarm -- but also opportunity, as the pervasive negativity could be signaling a turn in order for the market.

But first, the backdrop.

One of the most interesting things this year has been the way investors were sold on commodities as secure investments and the wave of the future. The only harder way to make money than options is in commodities. Moves are quick, and leverage, which is enticing when you enter, wipes you out faster than a speeding bullet.

Yet when the stock market wasn't working, the hedge funds all ran to currencies and commodities to try to fill the performance gap. Most didn't do very well last year, and they aren't doing better now. After a vigorous rally of record proportions Thursday, the **S&P 500** and the Russell 3000 are just about flat for the year. The **Dow** is up a whopping 2.2%, and the **Nasdaq** is down 4.3%. This is despite the fact that earnings progress at many companies has been stellar. That only increases the values in U.S. stocks, providing an important underpinning to an eventual move higher.

The **Federal Reserve** has ratcheted interest rates higher, in part to reduce speculation across the board. Housing prices are fading as the cheap-money environment has ended and the prospect of successfully "flipping" real estate has diminished markedly. Real estate isn't a liquid asset like a stock or a bond. You might not like the price at which you sell stocks or bonds, but you know you can sell them today; a house can sit around for months until a buyer appears.

While unemployment is at very low levels, consumer confidence has fallen considerably of late, reflecting higher housing costs, higher energy costs and a lack of confidence in our government to find effective solutions to myriad national problems: We are barely funding research into alternative energy. There is no quick fix for Iraq. The tax burden on the middle class is onerous. Health care costs are running out of control as our population ages. Globalization is affecting our work force. The list of problems is long and tiresome.

Now, the Good News

The good news is that although housing prices have stopped bubbling higher, they are still substantially above where they were five years ago. Because homes are the principal asset for most Americans, this is an important factor. Unemployment is at very low levels and inflation has been contained so far. Even last week's core inflation numbers aren't as bad as they seemed at first glance.

Owners' equivalent rent (a measure of the rent homeowners could charge for their houses) rose 0.6% in May. OER represents 30% of the core CPI and pulled the entire number higher. This probably reflects rising interest expenses on floating-rate mortgages for those who didn't lock in a fixed rate when rates were much lower last year. Rent, by contrast, rose only 0.3%. Removing this factor, core CPI was up only 0.18% according to an analysis by Citibank. The hoopla is really about whether the Fed will raise rates too far to crimp future inflation.

Last week, the percentage of **NYSE**-listed stocks below their 50-day moving averages fell to only 11%, a screaming buy signal for those who dare to lift their heads out of the trenches. That reflects the despair you see at significant turning points in the stock market. It never seems like it at the time, but it becomes clear in retrospect that you were being offered stocks on a value platter.

Sound 'Bies'

On June 12, I attended a briefing by Fed Governor Susan Bies in Washington with a small group of members of the Financial Women's Association. Bies made it clear that the Fed is well aware that it takes nine months or more for interest rate actions to percolate through the economy, so it is on a tightrope. When I asked if Ben Bernanke was duct-taping the mouths of the Fed governors to get them all "on message," she said no. They are free, as they have always been, to say what they think.

She said Alan Greenspan picked the right moment to exit, because the Fed must now read the tea leaves in exactly the right way to operate effectively. She emphasized the Fed's data-dependence theme -- one must wonder how the central bank viewed the CPI data last week. The consensus seems to be that 5.25% should do it.

I almost wish the Fed would go to 5.5% and get it over with. Then it has more room from which to lower rates once that becomes necessary. Long-term rates (10-year) are not reflecting big expectations of inflation really revving up, and I agree with that camp.

Your Friends, Gloom and Doom

The Gloom and Doom Twins are always an investor's best friends. When nobody wants to brag about their investing prowess, you know the pain is widespread, as it has been lately. Investors have been barreling out of the market and into money market funds. That's a good thing. Put/call ratios have been approaching levels that always create buying opportunities. Remember, collective actions such as these are exactly what happened at the bottom in October 2002, March 2003 and last year in May. Speculative excesses are being squeezed out of the market. Stocks always drop much faster than they rise. I believe that process is near its end.

Soothing comments from Ben Bernanke should help investors feel more sanguine about keeping their funds in U.S. stocks in the days ahead, if Thursday's vigorous rally is any measure.

Favor Small- and Mid-Cap Stocks

Small- and mid-cap stocks will fare better than large-caps if the economy softens. I expected a growth rate of 2% to 3% in 2006 since late last year. My view hasn't changed, but it implies a slower second half.

The GEs and Home Depots of the world are hard-pressed because they struggle to grow when the economy slows down, whereas small- and medium-size growth companies can still take market share or introduce new products that can have an impact. They grow faster when times are robust, and they can continue to grow when times are not. They are also more nimble and able to respond quickly to changing conditions in the marketplace.

Just be careful not to pay too high a multiple for any stocks you buy now, large or small, nimble or not.

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Under no circumstances does the information in this column represent a recommendation to buy or sell stocks. Lappin appreciates your feedback;
