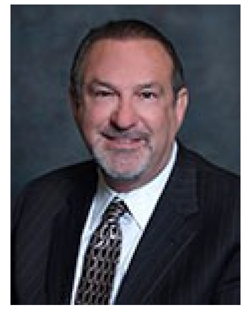
ADVISOR PERSPECTIVES

Ned Davis – Still Positive on Stocks

By Robert Huebscher
November 23, 2010



Just over a year ago, Ned Davis correctly forecast a continuation of the cyclical bull market in stocks. In February of 2008, he foresaw that year's market upheaval, and a year later he predicted the rally that began in March of 2009.

Today, Davis is moderately bullish on stocks, as long as the Fed maintains its policy of quantitative easing.

Davis, president and senior investment strategist of the Florida-based institutional research firm Ned Davis Research, spoke at last week's Financial Advisor Money Show in Orlando.

The hallmark of Davis' approach is synthesizing a range of objective data points into a model that, working from a lengthy historical track record, yields predictive signals for market movements. In his presentation, he illuminated many of the key data points on which his model is currently relying.

Momentum, liquidity and other key indicators

Davis is guided by two overriding principles: Don't fight either the tape or the Fed, at least without a *lot* of contrary evidence. His main cyclical indicator of the "tape" (overall market direction) is something he calls "big mo" – for momentum. According to Big Mo, 82% of the industry groups Davis follows are in "healthy" trends – a bullish reading.

Investment-grade bond yields, as measured by Moody's Baa index, are Davis' guidepost for Federal Reserve monetary conditions. Davis noted a strong inverse correlation between those yields and equity prices; when yield momentum is falling by more than 3%, stocks typically rise by 16.5% annually. He said interest rates are still falling but have moved up a little bit recently, and that uptick has moved this indicator from bullish to a neutral zone.

Davis presented a chart showing the M2 money supply, adjusted for commodities and industrial production. Because the Fed supplies a certain amount of liquidity to the market, and because the economy uses up some of it while inflation eats up another portion, Davis said it is telling. It shows that when there is excess liquidity – "which there certainly was in 2009," he said – "a monster stock rally" usually ensues.

In the spring of this year, this measure of liquidity was low – an ominous sign for the market. However, once the Fed announced its QE2 policy and its plans for fighting inflation, the indicator started to improve a bit. He also noted that the other monetary aggregates – MZM and M1 – "are showing pretty strong growth rates."

"Clearly, we think the Fed is friendly," he said, "and that is positive for the market."

Turning to market sentiment, Davis said that "crowd psychology drives most of the movements in the stock market." Markets typically peak at times of maximum optimism and bottom when sentiment is most pessimistic. He showed that the ratio of assets in money market mutual funds to the total market value was at an all-time high in March of 2009 (at the market low), when money market funds represented almost half the value of the entire stock market. Since then, there has been a tremendous outflow of roughly $1 trillion from money market funds. Davis said he is worried that so much liquidity has been used up, but he is buoyed by the fact that the remaining $2.8 trillion in money market funds is earning almost no interest. While some investors may tolerate those conditions, Davis said the Fed's zero-interest rate policies are creating "enormous pressure" to exit those funds, and there is still sufficient liquidity based on this indicator.

Consumer confidence, Davis said, is more about the economy than the markets, but he noted that it peaked at two notable market tops – in 2000 and again in 2007. In March of 2009 it was at a record low. Today confidence is extremely pessimistic. "Whether it is justified or not, that is the fact," he said. "This is a bullish factor for the market," since pessimism has historically coincided with market lows.

Wall Street earnings estimates provide additional insight. For the next year, Wall Street analysts are looking for about a 20% gain in earnings, he said, which is optimistic by historical standards. Even if those analysts are right, however, the market may still go down. In addition, Davis said profit margins are at historical highs, which he said is a negative factor.

Davis' preferred metric of market valuation ranks the component stocks of the S&P based on P/E ratio and takes the P/E of the stock in the middle. Currently, that median value is 17.2, just above the 42-year mean of 17. To Davis, that means the S&P 500 is fairly valued at approximately 1,150 – just below its current value.

Mutual funds are fully invested, and their cash holdings are near their all-time low, Davis said, which are negative signals. "We've got this interesting dichotomy that I really can't explain between incredible pessimism on main street and very high optimism on Wall Street," he said.

Davis cited several technical factors – support levels for the S&P and 1,150 and 1,130. Over the short term, Davis does not expect the market to go any lower than 1,130 but, if it does, he said, "it would be a very bad sign."

Emerging markets have been a theme of Davis' investment recommendations for the last five or six years, because of what he called "Asia-driven commodity demand." He noted that Asian countries are in much stronger fiscal positions than developed economies, and he projected 6.7% growth for the former versus 2.3% for the latter.

"Of course there are lots of powerful stories," Davis said. "There is a limit, and the limit to powerful stories is value and price. So this is not the beginning of the emerging market bull market. We think it is still ongoing." He noted, however, that he is not as bullish on emerging markets as in prior years, and Davis said his indicators are nearing levels where he would begin to have pause.

Debt and the economy

Turning to the broader economy, another of Davis' long-term themes is that excessive debt saps economic growth. He noted that debt as a percentage of the GDP was relatively low and flat during the 1960s, 1970s, and 1980s. In the mid-1990s debt really took off and exploded, he said.

Davis also showed a chart of nominal GDP, which he said was much like a mirror image of the one above. "The more debt we have, the more principal we have to pay back, and the more interest we have to service," he said. "It just sucks the life out of the economy, and it also sucks the life out of inflation."

Davis has calculated the amount of debt required to produce each dollar of GDP. Over the last 60 years, that ratio grew steadily, most dramatically in the last 10 years. Over the last decade, it took almost $6 of debt accumulation to produce $1 of GDP, Davis said, nearly doubling the ratio of the previous 10 years. "To me, that is excessive strain."

Over the last 30 years, Davis said, government spending has averaged 21.5% of our economy and nominal GDP growth has been 5.8%. The prior 30 years government spending was only 18%, and yet nominal GDP grew 8%. "So it seems like to me we are not really getting our dollars' worth for the spending we are doing," he said. Currently, he added, government spending is nearly 25% – an all-time record.

Davis acknowledged that commodity prices have been rising sharply – some of which is driven by Asia – but he does not believe inflation is a threat. Capacity utilization, he noted, is still very low, which will dampen any prospective inflation.

It's all about income

"The economy is all about income," Davis said, because excess disposable personal income drives consumer spending.

A measure known as “tangible assets” – basically, housing as a percentage of disposable income – has now reverted to its pre-housing bubble levels. Housing prices may go a little lower, Davis said, but for the most part they have stabilized.

Financial assets, as reflected in equity holdings relative to income, have gone through two bubbles, in 2000 and 2007. Davis said they are now “reasonable based on income.”

Household net worth has not stabilized in the same way as tangible or financial assets, Davis said. Household debt relative to income is still historically high across the economy, although he said the Fed’s zero-interest rate policy is keeping that debt “manageable.”

Nonetheless, Davis said further deleveraging will be necessary to eliminate excess debt and provide the basis for robust economic growth. “It has to be written off, defaulted, or refinanced,” he said. “We’ve got to get that bubble of debt down to where it is in line with incomes.”