



Investment Insights

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What ails the stock market?

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After a rousing start to the year, the stock market has dipped into the red due to the recent weakness begun in May. Through June 13th, the S&P500 showed a total return of -1% for the year. Not a terrible number, but markedly different than the 5% gain the market had through the end of April. So what's going on? Why the sudden negativity?

As is typically true, there isn't a simple or single explanation for the reversal. Rather, it's a combination of factors that have affected short-term sentiment and driven stock values down. First on the list of culprits is inflation, the arch-nemesis of the Federal Reserve. Inflation has been a headline issue for months: remember seeing anything recently about the high price of gas, homes, or gold? Although prices of most everything have been rising for months, the market has now taken notice and decided it is cause for concern. In particular, the fear is now that the Fed will have to continue to raise interest rates to slow the economy down and combat inflation. Hopes were that the Fed was near the end of the cycle of raising rates, but that sentiment has changed, and prognosticators expect at least one more hike in rates, at the Fed meeting later this month.

A second factor I believe is coming into play is simply that we've gone much longer than average without a correction in the stock market. A correction is defined as a decline of 10% or more occurring over a period of a few months, and we usually see corrections every 6-9 months. Through April of this year, it had been over two years since we last experienced a correction in the US stock market, so it was natural to expect one sometime soon. As of June 13th, the S&P500 had declined nearly 8% from its peak reached May 10, 2006 (and the more volatile NASDAQ index was down over 12%). Corrections are a healthy "breather" for the market, and this may turn out to be just that, a "pause that refreshes".

While moves in markets over the short-term are largely based on emotion, it is fundamentals that drive long-term direction. Thus, the concern is really how fundamentals look right now. In that regard, there are still many positives to take comfort in: valuations are not high by historical measures, long-term interest rates haven't risen much at all, and earnings remain strong (first quarter results showed earnings gains of 14% on average for the top 500 US companies-the 16th straight quarter of double-digit earnings gains). Contrast that to the recent bear market, where company profits declined by almost 40% from June of 2000 through September of 2001, long-term interest rates

had risen from 4.5% to nearly 7%, and the market at its peak was valued at more than twice its historical average (as measured by the price/earnings ratio).

It's always important to watch the fundamentals for signs that conditions are changing. Understanding the risk associated with your own investment strategies is also critical. Focusing on these matters, and not putting as much weight in the day to day swings of the stock market, could keep you from making the mistakes that plague many individual investors.

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