

BARRON'S

JUNE 22, 2009

Four-Week Winning Streak Over, What Now?

By KOPIN TAN

Stocks' four-week winning streak ends.

THE STOCK MARKET absorbed its first loss in five weeks, but the pullback says respite more than regret -- for now.

With traders anticipating a correction, the Standard & Poor's 500's failure to overcome the 950 threshold after a 10-day siege might have triggered heavy selling. But stocks halted their decline after three days. Instead of selling stocks to hoard cash, investors also remained in the market by shifting capital into defensive sectors like health care and consumer staples.

Crude oil, too, suffered its first weekly loss in five weeks as traders stepped back from the increasingly crowded "reflation trade," which involved betting on commodities and emerging markets and shorting Treasuries. But despite rising gasoline prices, inflation data last week showed consumer prices increasing at a slower-than-expected pace in May, and the decline over the past 12 months was the biggest since 1950.

The Dow Jones Industrial Average ended the week down 260, or 3%, to 8540. The S&P 500 suffered just its second loss in eight weeks and fell 25, or 2.6%, to 921; it is still up 36% from its 12-year low on March 9. The Nasdaq Composite Index gave up 31, or 1.7%, to 1827 and is up 44% since early March, while the Russell 2000 declined 14, or 2.7%, to 513.

Is the rally flagging? Stocks couldn't muster much momentum even after leading economic indicators increased 1.2% in May to string together their first back-to-back improvement in three years. Research in Motion (ticker: RIMM) shares slipped 5% Friday after it reported a 33% profit jump and issued a hardly shabby forecast -- another sign much good news is priced in. On the other hand, the government's pledge to overhaul financial-sector rules barely dented bank stocks.

New bull markets are born of swelling volume and growing assurance, so it's hardly encouraging that stocks pushed to a seven-month high in June just as volume shriveled to its lowest levels of the year. "The diminishing volume pattern over the past several weeks indicates a lack of conviction," notes Brown Brothers Harriman analyst Andrew Burkly, who recently shifted from bullish to neutral to await a better buying opportunity.

The economic recovery will be patchy, and a resumption of the boom years' exalted growth and muted inflation is unlikely, say Merrill Lynch's strategists. But "monetary, fiscal and financial policies have likely created a strong floor for credit and equity markets." As bulls and bears fight it out, expect the S&P 500 to flit between its May low of 883 and its recent high near 950.

WITH STOCKS UP NEARLY 40% since March, Harry Rady, chief executive of Rady Asset Management, recently shifted 70% of the firm's holdings into cash. While the San Diego money manager holds some stocks he considers undervalued, from King Pharmaceuticals (KG) to Morton's Restaurant (MRT), nearly half of a long-short fund he manages now holds bearish bets. "We may have staved off a depression, but there's still a prolonged recession of several years ahead," Rady says.

Among his concerns, the profligate debt ailing our economy hasn't been purged, but merely transferred from the private to public sector. Fixing this excessive debt-to-asset imbalance requires either inflation of assets, which has inconvenient side effects, or the selling of assets to pay debt, which isn't practical after

the recent drastic depreciation.

Against this backdrop, some consumer stocks are pricing in more pep than the economy can muster. Pool (POOL), for example, is a distributor of swimming-pool supplies and equipment suffering through the worst year on record for new pool construction. Sales could slide by the low double-digits this year from last. Yet shares have rebounded 53% since March 9 to outstrip even home builders -- although any housing-market pickup won't trickle down immediately to pools. Pool is swimming in long-term debt (roughly 61% of capital), and shares fetch 16.5 times projected 2010 profits -- well above the 11.2 times for the inflated leisure-products sector.

Big 5 Sporting Goods (BGFV) shares had quadrupled since late November despite what is essentially a second-tier franchise selling commoditized sporting goods. But the market's embrace of consumer cyclical stocks has lifted Big 5 from 7.7 times forward earnings to 15.5 times in mere months.

AutoNation (AN) shares also have quadrupled recently, to about 17. Sure, auto sales are declining at a slower pace; CarMax (KMX) last week reported first-quarter profits that beat expectations, and industry consolidation should boost margins at the car and parts seller. But AutoNation still has "significant exposure to domestic car makers," Rady says. Shares worth 5.9 times forward earnings late last year have quickly swelled to 16.8 times, overtaking even the rallying broad market.

SIFTING FOR SMALL STOCKS to buy got tougher after the Russell 2000 rose more than 50% in three months. But the recent reflexive lunge for all things small and economically sensitive wasn't focused exactly on balance-sheet quality. "Given the de-levering going on, some companies have paid off a lot of debt but haven't gotten a lot of credit for it," says Eric Cinnamond, manager of the Intrepid Capital Small Cap Fund (ICMAX).

One such company is Prestige Brands (PBH), which markets and sells a vast range of household and personal-care products including Chloraseptic sore-throat lozenges, Clear Eyes eye-drops, and Comet bathroom cleansers. Prestige has quietly pared its debt to \$340 million from \$490 million at the end of 2006. Sales suffer during the recession as retailers trim inventory, but free cash flow remains robust.

Prestige can withstand pressures on the range of products retailers sell since it owns category-leading brands. At 10.7%, its net profit margin is nearly twice the average 5.6% for the personal-products segment. Yet shares trading near 6 fetch just 8.7 times projected 2009 earnings, well below the 17.5 times for its peers.

Rent-A-Center (RCII) has cut its debt load in less than three years from \$1.2 billion to about \$730 million. The Plano, Texas, company lets consumers rent everything from flat-screen TVs to furniture, with a view to eventual ownership, and it is one of the few places today where poorer Americans can still get credit for big-ticket purchases. Investors fret about waning demand and default risk in a prolonged recession, but analysts expect free cash flow to reach \$275 million this year.

Shares, which did well during the last recession, have rebounded 50% since late November but still trade at 7.4 times 2010 earnings, below 10.8 times for electronic retailers. Intrepid owns both the stock and bonds yielding 9.34% that mature in 2012.

Meanwhile, Applied Signal Technology (APSG), a defense intelligence stock Cinnamond flagged here on Feb. 9, has run up 47%, outpacing the 9% gain for the Russell 2000 over the same period. Shares are no longer under-appreciated, and the smart move might be to take profits.