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Some Thoughts on the Dow and the Stock Market

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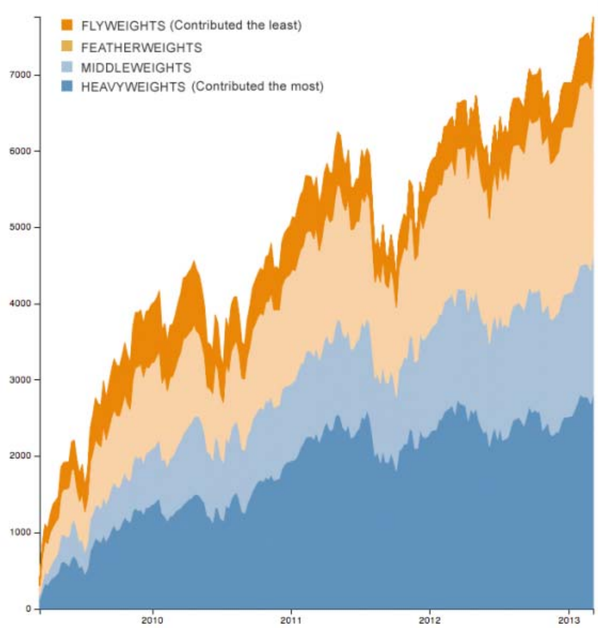
Nearly four years to the day of its low point of 6,547, the Dow Jones Industrial Average set a new record of 14,253, topping its previous all-time high of 14,164 And it posted another 42 point gain on March 6. ***Many people are wondering if this is the top, the middle, or still the bottom? Does this stock market still have legs?***

The Dow

First, let's set a few things straight about the Dow. We have long argued that it is an imperfect form of shorthand invented in 1896 to easily calculate with simple math how the stock market is doing. However, it is <u>not</u> the stock market—it is just 30 stocks. In fact, some very major companies such as Apple and Google aren't even in the Dow. Today's Dow isn't the Dow of 2009. Travelers and Cisco replaced Citigroup and General Motors; Kraft was replaced by United Health.

These 30 stocks in the Dow are not weighted evenly. In fact, they are weighted by their share price, not by their market capitalization, which is the number of shares multiplied by the price per share. This means that a company with a high price per share, but with a mediocre performance could have a disproportionate effect on the performance of the Dow.



Company name	Change(%)	Pts.
Hewlett-Packard	-20.21	-34.49
UnitedHealth Group	200.73	-20.58
General Motors	-48.81	-6.49
Cisco Systems	55.73	10.62
Citigroup	229.52	19.2
Alcoa	54.92	24.55
Bank of America	208	62.74
Intel	71.39	68.28
Microsoft	87.13	102.48
AT&T	68.51	113.68
Pfizer	122.25	118.1
General Electric	218.35	125.25
Kraft Foods	96.23	156.88
Merck	106.05	170.27
Verizon	94.96	178.4
Exxon Mobil	38.78	193.37
Wal-Mart Stores	55.17	199.86
Johnson & Johnson	66.65	239.77
DuPont	201.61	250.28
Procter & Gamble	74.4	253.58
J.P. Morgan Chase	211.26	263.24
Travelers	143.02	287.58
Coca-Cola	99.66	301.69
Walt Disney	262.28	314.06
McDonald's	83.12	333.26
Boeing	153.74	369.41
Home Depot	286.56	400.02
American Express	502.63	411.32
United Technologies	142.33	413.62
Chevron	102.35	456.63
3M	148.28	480.81
Caterpillar	277.13	507.56
IBM	147.4	941.77

As you can see in this chart from the March 6 *Wall Street Journal*, five "heavyweights" (IBM, United Technologies, 3M, Chevron, and Caterpillar) contributed the most to the Dow's four-year performance. High-priced stocks like IBM, which rose 147%, added nearly 942 points to the rebound. Others, such as Bank of America, which surged more than 200%, added slightly more than 62 points.

Not every stock in the Dow has bounced back. In fact, 12 of the 30 stocks in the Dow are still down from their peaks, some of them spectacularly so, such as Alcoa down 79% from its peak.

Finally, in real (inflation-adjusted) terms, the Dow on a price appreciation basis is actually down from its 2007 high by 9%, according to Ned Davis Research. From 2000, it is down by 11%, which would make it the equivalent of 10,424. To reach a high in inflation-adjusted terms, the Dow would need to hit 16,052, up 13% from the March 5 close. That's just on price. What happens when we factor in dividends that all 30 companies of the Dow have paid since 2007? Then, according to CNN Money, the Dow is up an impressive 20%, and a 6% real return.

The Stock Market

Beyond just the Dow, what about the rest of the stock market? The S&P 500, an index of the 500 largest American companies also closed at its highest level from October 2007. So what's going on? Can it continue? We think so. First, the negatives:

The Negatives:

- The stock market and the economic recovery are uneven.
- Much of the home buying (and thus higher home prices) are from investors buying large blocks of foreclosed properties or from homebuyers fearing price increases, as opposed to new factories coming into town attracting hundreds of jobs.
- Unresolved US budget deficit issues and the gridlock that accompanies it. (Apparently, the stock market seems to be looking beyond this.)
- Unemployment and underemployment hinder consumer confidence and spending.
- Although things have improved, Europe is still not out of the woods yet.
- Budget cuts and the subsequent job losses from sequestration may reduce the GDP.
- The Fed may "remove the punchbowl" from the party too early. (See below)

The Positives:

- The Fed's accommodating policy of very low interest rates. Many analysts attribute this policy as the major factor of the market recovery, as there are few "safe" alternatives that have positive real rates of return.
- Strong housing starts and prices. New housing triggers other things like appliances and furniture sales.
- Improved economic data in manufacturing, exports, and services.
- Corporate profits are at or near record highs. In fact, they are 37% higher than they were at the last market top in 2007, according to CNN Money. Much of this is due to technology enabling companies to do more with less employees and because of lower borrowing costs.
- Strong investor sentiment. It takes both strong fundamentals and positive investor sentiment. We've had good fundamentals for the past two years, but sentiment was negative, and so the demand for stocks just wasn't there.
- Except for the recent election in Italy, the European economy is showing signs of recovery, and the sovereign debt issue seems to have stabilized.
- Good growth in South America and moderate growth in Asia. Many of our leading companies have strong sales abroad, so that they can prosper even while our economy hasn't fully recovered.
- Corporate balance sheets are strong, and price-earnings ratios are reasonable.
- A record amount of investor and corporate cash is still sitting on the sidelines. Sooner or later it needs to go to work.

So overall, we believe the positives outweigh the negatives. There is room for more growth in stocks. However, as you might have guessed by the beginning of this paper, there can be a big difference between market indexes and the companies within them. Wall Street and Main Street have often moved in different directions over the years. So while the employment numbers don't look good and the shop downtown is closed, Wall Street may be faring better because of some of the things mentioned above, especially considering how global the world has become.

Two other things to consider:

- The stock market often over-reacts to extremes. This happened in 2000 on the high side and in March 2009 on the low end. We might need some time for the market to simply rest and digest its gains.

- The market will go down again as part of the normal business/market cycle. Nobody knows when, but as one client noted, "Business cycles happen and Congress can't repeal them."

Until then, savor the moment! For those who stayed invested, congratulate yourself. It wasn't easy but you did it. Remember these good times during the next inevitable correction which will happen at some point in the future.