



Bullish



Predictions

A continuing bull market will outshine talk of a recession in 2008

BY MICHAEL MARKOWSKI

With angst over the U.S. economy fueling the widespread consensus that we're heading toward a recession, I decided to let the numbers (cash flows) speak for themselves. According to StockDiagnostics.com's proprietary cash-flow data, the United States has not, and most likely will not, enter a recession, nor will we see a new bear market. Cash-flow data shows that the lows since the summer of 2007 will prove to be a significant correction in a continuing bull market for stocks.

I also believe that the lows for the major indexes, including the NASDAQ 100, the S&P 500, and the Dow Jones Industrial Average composite indexes, were made on March 10, 2008—the day before the U.S. Federal Reserve Bank announced that with the assistance of two other European central banks, it had created a new \$200 billion credit facility that could be used by banks and brokers to finance AAA mortgage-backed securities.

There are eight reasons for my bullish predictions:

1.) Cash flows are accelerating.

StockDiagnostics.com's most recent cash-flow data for the aggregated nonfinancial components of the three major indexes indicates that there will be robust and record earnings growth for each of them during the second half of 2008. Here's why:

- Cash flow from operations for the Dow Jones Industrial Average hit a record \$373 billion for the latest 12 months, compared to \$296 billion for the comparable 12 months in 2007. The NASDAQ 100 and the S&P 500 indexes also generated record CFFO. This means that annualized CFFO for the S&P 500 increased by \$300 billion (50%) and the NASDAQ 100 by \$30 billion (100%) since the bull market began in October 2002.

- Free cash flow also hit records and actually grew at a faster rate than CFFO for each of the three indexes over the latest 12 months. The Dow's FCF led the other two indexes with a 50% growth rate over its latest 12 months, and annualized FCF growth rates for each of the three indexes has been accelerating for the four most recent consecutive quarters. This is in stark contrast to what happened at the peak of the last bull market in 2000, when, during the third and fourth quarters of 1999, the FCF growth rate for each of the three indexes peaked and began to decelerate. This culminated with a negative FCF growth rate for both the Dow and the S&P by the third quarter of 2000, and again two quarters later for the NASDAQ 100.

The accelerating FCFs for each of the indexes over their past four consecutive quarters is the main reason I believe that the current downturn will prove to be a bull-market correction instead of a new bear market. The previous market peak, from 2000 to 2001, was preceded by four consecutive quarters of decelerating FCF growth, while reported earnings growth was simultaneously accelerating. This is precisely what should happen at the end

CASH FLOW FROM OPERATIONS

Cash flow from operations is an extremely important indicator that can be used to diagnose the true health of a company and its future prospects. Here's an example: When Boeing (NYSE: BA) announces or gets another new order for its planes, the customer must give Boeing a deposit. The deposit is booked and is reflected on its cash-flow statement and balance sheet, but it has zero impact on its income statement or its earnings that it reports to the Securities and Exchange Commission. It's only after Boeing builds the plane and the customer accepts delivery that the revenue and the profits from the sale of the plane are booked on Boeing's income statement or earnings report. That is why, in my opinion, the monitoring of cash flow is essential in making investment decisions.

of a bull market or economic cycle—it's as simple as Economics 101.

Conversely, the start of the new bull market in October 2002 was preceded by four quarters of accelerating FCF and four quarters of negative double-digit earnings declines. Again, this is what should happen at the start of a new bull market or economic cycle. The most recent annualized FCF data is indicating just that: The accelerating FCF growth rate of 53.1% for the Dow is the highest since January 2000.

Accelerating Free Cash-Flow Growth Rates Dow Jones Industrials Q2-07 to Q1-08	
Period	FCF Growth Rate
Q2-2007	-3.3%
Q3-2007	18.3%
Q4-2007	31.9%
Q1-2008	53.1%

Decelerating Free Cash-Flow Growth Rates Dow Jones Industrials Q4-99 to Q3-00	
Period	FCF Growth Rate
Q4-1999	100.7%
Q1-2000	69.5%
Q2-2000	16.1%
Q3-2000	-15.5%

2.) **Cash-flow-to-price multiples are at or near 10-year lows for each of the three major indexes.** The Dow's latest price-to-cash-flow multiple of 9.4 is the lowest since 1995. The only other time that the Dow's P/CFFO went below 10 was in October 2002. The Dow's latest price-to-free-cash-flow multiple of 15.5 is even more telling. It marks the lowest since 1995, when StockDiagnostics.com first started keeping records. To put this in perspective, the Dow's P/CF has fallen below 20 only 10 times in the last 51 quarters—compare that with a high of 63.3 in July 1998. In 51 of its latest quarters, 24 of them have closed with a P/FCF multiple above 25, 15 of them have had multiples in excess of 30, and 12 of them have had multiples in excess of 40. The other two indexes currently have P/CFFO and P/FCF multiples that are also at or near their 10-year lows.

Periods in Which Dow Jones Industrials Composite P/FCF Multiple Has Fallen Below 20	
Period	Low P/FCF Multiple for Period
Oct 2002 to Oct 2003	18.04
Oct 2004 to Oct 2005	17.74
Oct 2007 to Apr 2008	15.53

Behavior of Dow Jones Industrials' P/FCF Multiples, Latest 51 Quarters	
P/FCF Multiples	Low P/FCF Multiple for Period
P/FCF below 20	10/51
P/FCF above 20	41/51
P/FCF above 25	24/51
P/FCF above 30	15/51
P/FCF above 40	12/51

3.) **In the current environment, many public companies are likely to adjust or manipulate their results downward before reporting earnings or giving guidance.** The record CFOs and FCFs that many companies have reported over the latest 12 months suggest that this may very well be the case. Here's why:

- A CEO sees the shares of his company and the shares of all his competitors trading to major lows because of Wall Street's perception that his industry will be impacted negatively. The CEO decides to hold back shipments of the company's products so that they will hit its income statement in a subsequent quarter in the future—and shipping goods on April 1 instead of on March 31 would accomplish that. This ensures that the subsequent quarter will be more profitable than the current one. By doing this, the CEO can use earnings once the psychology of the stock market has improved, which could send the shares much higher. Why announce good news when it is not going to help, especially given the extreme pessimism and widespread new lows that the stock market endured during the first quarter of 2008?

- Also, many companies typically grant stock options to their executives and employees in the first quarter, which is right after the

close of their calendar year. This is another reason executives would want to move good news into future quarters. It's much more difficult for a CEO to manipulate cash flow (CFFO or FCF), and that's why investors should pay close attention to the record cash flows that are being reported by the non-financial company components of the three major indexes over the most recent four quarters.

4.) **The credibility of the U.S. Federal Reserve and Chairman Ben Bernanke has skyrocketed.** This was caused by the Fed's announcement that it was creating a new \$200 billion credit facility with the assistance of two other European central banks. I believe that as we look back, the move will prove to be a major psychological turning point for the liquidity crisis and the stock market. It signaled that the Federal Reserve was willing to be very creative in finding solutions, and the involvement of two other central banks indicated that the U.S. was not alone and that other foreign governments and their central banks were willing to help in solving the liquidity problems.

5.) **Investors are overly bearish.** Market bottoms tend to occur when a majority of investors believe that the market is headed even lower. Investor sentiment

FREE CASH FLOW

Free cash flow is also an extremely important indicator because it is the net amount left over from CFFO after a company makes its capital expenditures or purchases its manufacturing plants and equipment. Let's look at Boeing again. After it receives its cash deposits from all its customers, the cash that is required for its capital-expenditures budget is subtracted from its CFFO. The net amount that is left over is its FCF, which enables a company to have the cash available to pay dividends to its stockholders, make acquisitions, or buy back its shares. Without true FCF, none of these things could happen. This is the main reason Citigroup (NYSE:C) recently cut its dividend—it has not generated positive FCF for some time.

reached its lowest levels since October 2002 (the start of the current bull market) on March 12, 2008. According to the Investors Intelligence Survey, the number of bears exceeded bulls by almost 30% for the first time since 2002. Investor pessimism also reached its lowest point since 1998. The put/call ratio (the number of puts being purchased versus the number of calls) spiked to a level of put buying that had not been seen in years. After the Fed's announcement, advancing stocks on the NYSE outnumbered declining stocks by a magnitude that had not been seen in prior sell-offs.

6.) The market bottoms for all indexes have already been severely tested.

One week after the bottom or lows for each of the indexes occurred, the announcement was made that Bear Stearns was going out of business and that it would be absorbed by JPMorgan. A major sell-off of the financials ensued, but the indexes on that day closed well above the lows. The fact that the indexes did not penetrate the lows on the Bear Stearns announcement is significant. And the fact that the biggest broad-based rally for 2008 occurred the very next day after the Bear Stearns news—when the Federal Reserve lowered its bench-mark rate from 3% to 2.25%—gives more credence to the fact that investor psychology had changed.

7.) The failure of Bear Stearns and the Federal Reserve's quick remedy is good medicine for the market.

The rumor that Bear Stearns had been having difficulties had gone on since late last summer and had cast a negative pall over the financials and the overall market. Now that it has happened and Bear Stearns' announcement did not cause a severe financial meltdown, the market has lifted emotionally. The three major indexes dropped sharply on Bear Stearns' bad news on March 17, 2008, but they did not pierce the intraday or closing lows that occurred one week earlier. The fact that the lows were tested but not breached on such news is very bullish.

8.) History tends to repeat itself. The current climate or situation, which includes the global liquidity crisis, the fail-

ure of Bear Stearns, the multidecade highs for commodity prices, and a sharp correction in the stock market, is reminiscent of 1980. Back then, the prices of gold and silver soared to record highs because of a 13% inflation rate. Silver peaked at more than \$50 per ounce in late 1979, at which point the Federal Reserve intervened to put an end to the wild speculation on gold and silver. Silver subsequently started declining and suffered its worst one-day decline of 50% when its price plummeted from \$21.62 to \$10.80 on March 27, 1980. Silver's rapid demise caused big problems for the stock market as the Dow Jones Industrial Average traded down to 759.98, its low for 1980. (It had peaked six weeks earlier at 903.84.) Based on the intraday highs and lows, the Dow declined by 20% over the short six-week period. The Dow's downward spiral came when the venerable investment-banking firm of Bache Halsey Stuart had to be liquidated because of the failure of the Hunt family—one of America's wealthiest families—to meet margin calls. Two of the family's brothers had used a margin account to purchase large quantities of silver on margin at ridiculously high prices, and when they collapsed, Bache had to be rescued. By July 1980, the Dow had fully recovered and closed above its February high. It closed in 1980 at 963.69 for a one-year gain of 16.8% and a gain of 26.7% from its 1980 closing low of 759.98. Having lived

through the 1980 crisis, I can attest to the fact that the collapse of Bache was just as ominous as the collapse of Bear Stearns.

THE BOTTOM LINE

The shares of many of the nonfinancial companies that reside in the three major indexes are quite cheap and are poised for significant appreciation—one simply has to examine their historical price-to-cash-flow multiples. Additionally, annualized aggregated cash flows (CFFO and FCF) of the nonfinancial components are at record highs and are accelerating for each of the three indexes.

This accelerating cash-flow momentum should more than offset the problems, including the severe share price declines that will continue on for their financial brethren. I expect that many nonfinancial companies will announce significant earnings surprises in the second half of 2008 and that this will bode well for the stock market. Because of the accelerating record FCF, I also expect a flurry of takeover activity and stock buybacks to start in the second half of 2008. Finally, I predict that by the end of 2008, the three major indexes will at least flirt with and possibly take out their 52-week highs set in October 2007. There are a number of companies that I am recommending that have accelerating FCF. Each of them has also grown their FCF at a rate of more than 100% over the last 12 months. **E**

Markowski's Picks of Companies that Reside in the Dow Jones Industrials, S&P 500, and the NASDAQ 100		
Company	Symbol	FCF Growth Rate %
Super Valu	SVU	409.50
Transocean Sedco Forex	RIG	369.00
Thermo Electron	TMO	297.70
Starwood Hotels	HOT	296.10
Allegheny Technologies	ATI	258.00
PMC-Sierra	PMCS	237.90
Ciena	CIEN	229.10
Millipore	MIL	225.80
JDS Uniphase	JDSU	181.50
Nvidia	NVDA	145.00
Best Buy	BBY	124.60
Hasbro	HAS	121.50
Northrop Grumman	NOC	116.40
General Electric	GE	100.80

To qualify for this list, each company had to have accelerating annualized free cash flow.