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TrimTabs Liquidity Analysis Says Higher Prices Likely Over the 2Q03 and 3Q03

Charles Biderman, CEO, TrimTabs.com

Liquidity has been bullish for the first quarter of 2003. In fact, as the quarter ended, liquidity grew even more bullish despite headlines warning of an extended conflict in Iraq. This means that our analysis of the supply and demand for shares in the stock market suggests a rise in the broader stock market in coming weeks, if not months. It also means that market pundits who appear in the media warning that 2003 could be a repeat of 2002 may end up eating their words. While it's too early to say what the second half of this year looks like, liquidity analysis thus far this year is laying the ground for a bullish second quarter.

Before we go further, let's review quickly the elements of liquidity analysis. If you didn't read our introduction to Liquidity Theory in last month's issue of *Senior Consultant,* we encourage you to do so now. Here's a recap. Liquidity Theory has been demonstrated to explain the direction of markets weeks before they move, and to work in good markets and bad. We break it down into three components: L1, the most important factor, which follows the net change in shares available for trading. L2 tracks money going into or out of mutual funds, and L3 is the amount of margin debt used to purchase securities. The net float changes as companies remove shares from the market through buybacks or cash takeovers, and add shares through new equity offerings and insider selling. L1 shows that during the first three months of 2003, the net float shrank by $17 billion. In the three weeks through April 3, L1 shrank by $9.6 billion. One key reason for the change was the 15 new takeovers announced in late March and early April, totaling $3.5 billion. By the standards of the M&A heyday of the late 1990s, that's not huge, but it's the busiest two-week period since last May; and unlike last May, when new offerings were surging, offerings were at a much more tepid pace.

In short, the float of shares has shrunk considerably in the first quarter, which means there will be fewer shares available should demand for stocks pick up. This is a big change from the first quarter of 2002, when L1 increased by a bearish $69 billion. The S&P 500 closed the the first quarter of 2002 virtually unchanged, but tumbled in the second quarter when there were too many shares chasing less money.

So is demand picking up now? The flows we track in L2 show that in the first quarter saw an outflow of $19 billion during the first quarter of 2003. However, we regard equity fund flows as a contrary indicator: L2 is often bearish when L1 is bullish, and vice versa. Again, in first quarter 2002, investors put a net $51 billion into stock mutual funds while companies sold. Much of that money evaporated when stocks fell later in the year.

CONTRARY TO HEADLINES POINTING TO NEGATIVE JOBS DATA AND SLOWER SPENDING AMONG COMPANIES, U.S. COMPANIES AREN'T HALTING SPENDING DUE TO THE WAR

Now consider that there are $5.3 trillion in bond funds, cash savings accounts and retail money market funds that are earning next to no returns. That's equal to about 50% of the end of March market cap of all U.S. equities. At the end of 1994 and at the end of 1990, the same categories of sideline cash also equaled close to 50% of the market cap. In 1995 and 1991, the S&P 500 rose over 30%.

On the other side of the ledger, at the end of 1999, as the stock bubble was reaching its highs, the ratio of bond, money market and cash savings to stock market cap was a record low 21%.

So there's potential strong pent-up demand waiting for a signal to buy. A fast end to the war boosting stock prices a bit more could be such a signal.

So what we have seen this year — companies net buyers and individuals net sellers — is the mirror image of early 2002. We expect, barring an exogenous shock to the system, stocks will rise during the next quarter. By exogenous shock, we don't mean more war in Iraq, but something much more shocking like war moving to U.S. soil.

More significantly, rise in corporate buying and decrease in corporate selling may signal that U.S. companies are willing to buy their shares at these prices because they've finally eliminated most of their excess capacity, which in turn, would mean that any increase in topline revenue would translate into bigger cash flow.

Contrary to headlines pointing to negative jobs data and slower spending among companies, U.S. companies aren't halting spending due to the war. Yes, the "CNN effect" — where people put their lives on hold to watch the war on TV — did delay some action, but it didn't halt it altogether.

This is evident in the amount that companies withheld from income and employment taxes, which we regard as the best coincident indicator for the economy, reflecting changes in incomes. According to the *Daily U.S. Treasury Statement,* companies have been spending 1.7% more on incomes during the four weeks through April 4 than it did the comparable period a year ago. It was growing 4.6% year-on-year in early March before the war started, but has turned slower but overall positive since then. Withholding has been overall bullish since last July, showing a slow but steady trend of companies willing to spend more in anticipation of growth ahead. This supports the trend we've seen in L1, where companies are buying back stock as the capacity glut passes.

Bottom line: Unless there is a major terrorist incident on U.S. soil, we expect the stock market to rise in the next few months as companies shrink the overall float while cautiously increasing incomes to workers. That should prepare the market to rally on any sustained increase in stock purchases. And if the rally lasts several months, not only will some of the money in low-yielding cash accounts and underperforming bond funds start moving back into stocks and stock funds, but so will new savings. ■

About the Author

Charles Biderman began Trim Tabs Financial Services in 1990 to provide unique investment ideas to portfolio managers. Over time, Charles began developing Liquidity Theory as the key to the stock market. Prior to starting TrimTabs.com, Charles, a Harvard MBA, was associate editor of *Barron's Financial Weekly* and a successful real estate investor.

A Consultant Toolbox Solution

Senior Consultant, in conjunction with TrimTabs.com, has arranged for its readers to have a FREE one-month trial to TrimTabs Liquidity research. This research has very high predictive value on the direction of the market, typically 3-4 weeks before the market moves. Given the Iraq factor, this may be an opportune time to avail oneself to this information.

Notes

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SENIOR CONSULTANT

1457 Crystal Springs Lane
Richmond, Virginia 23231
Ph 804-643-1075 ■ Fax 804-643-1544
WWW.SRCONSULTANT.COM