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Liquidity Analysis: Has the Rally Gotten Ahead of Itself?

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Back in March, before the Iraqi war began we wrote in an article for *Senior Consultant* that after the war we expected the U.S. stock market to pop 20% to 25%. Since March 12, the S&P 500 has climbed almost 20% as this is being written. In a recurring pattern after a sharp increase in stock prices, companies have turned bearish on their own shares. Since the week ending April 10, companies have been heavy net sellers of their own shares. New offerings have been averaging over $3.5 billion weekly, and insider selling has surged since the end of earnings release season.

Not only have companies turned bearish on the stock market, but everyone else is now wildly bullish. The American Association of Individual Investors weekly survey had less than 20% of respondents now bearish over the past three weeks – the least in many years! Also, the volatility index is at lows not seen since before last June's big market sell off. Therefore, we have turned cautiously bearish over the near term. We do not think that this is a new bear market, rather the recent rally has gotten ahead of itself.

BUT FOLLOWING A SIGNIFICANT RALLY IN THE STOCK MARKET, CORPORATE BUYING CAN SLOW AND SELLING CAN PICK UP – WHICH IS EXACTLY WHAT WE'VE SEEN IN MORE RECENT WEEKS

As we have done for the past two months, Trim Tabs Financial Services offers readers of *Senior Consultant* a monthly liquidity analysis of the stock market to offer them insight into the changing supply and demand for shares, which can anticipate market trends. A model paper portfolio based on our liquidity analysis was up 74% in 2002. For a detailed explanation of Trim Tabs liquidity analysis, please reference our first article, "Liquidity Theory: A Means to Achieve Absolute Positive Returns in Any Investment Environment?" *Senior Consultant,* March 2003.

To summarize, we measure liquidity in three ways:

1. whether companies are net buyers or sellers of stock through cash takeovers, stock buybacks, stock offerings or insider selling (L1, the most important liquidity indicator);
2. whether money is flowing into or out of mutual funds (L2); and
3. how much margin debt was used to purchase equity (L3, which lags the other indicators and is the least useful).

In March, we saw companies had become net buyers of stock, helped largely by a rise in cash takeovers at the end of the month. Corporate buying caused L1 (the net float of shares) to shrink by $17 billion. A smaller float is bullish; in general, it allows for any increase in demand for shares to push prices higher. Sure enough, stocks did rise after L1 declined. Between March 10 and May 10, the S&P 500 gained 19%.

But following a significant rally in the stock market, corporate buying can slow and selling can pick up – which is exactly what we've seen in more recent weeks. In the three weeks through May 1, there were only $997 million in new cash takeovers, compared with $6.9 billion in the previous three weeks. It seems that, while buyers who have built up neat piles of cash are ready and able to spend them on new acquisitions, sellers aren't being very friendly about their advances. Companies may be interested in selling off unwanted operations, but they don't want to be bought outright. If the market does endure a sell-off, however, it could trigger some hostile takeovers.

For all of April, there were only $7.7 billion in new buybacks announced, less than half the monthly average of $17.1 billion during the first three months of the year. While the number of shares announced in buybacks did pick up slightly in the second half of the month in the aftermath of the war in Iraq, it was still well below levels seen earlier in the year.

While corporate buying slowed, selling picked up. In the last two weeks of April, there were $7.5 billion in new offerings. The week of April 25 alone saw 19 offerings priced and sold, the highest number since mid-December. Given the warm reception that many of these offerings are receiving, they will likely continue until investors tell the underwriters what Roberto Duran once said to the referee, "No más."

There was also a rise in insider selling toward the end of April. According to Bloomberg, the top 25 companies with insider selling totaled $1.8 billion during the week ended May 2, while insider buying at the top 25 buyers was just $10.8 million. And the widely reported sale of 50 million shares of AOL Time Warner by Ted Turner for $650 million has only added to the insider selling since then. All in all, L1 expanded by a slightly bearish $2.3 billion in April, marking the first month of expansion in the net float since last September.

During April, the sustained buying from individual investors, measured in L2, never emerged. In the week through April 16, they bought a net $8.7 billion in equity funds, but in the following week, they were net buyers of a mere $500 million. That surge came as people were putting money into 401(k)s and IRAs ahead of the April 15 deadline. But the surge was a seasonal blip. After the deadline passed, flows into mutual funds slowed dramatically.

More significant is the sudden post-war bullishness that has seized individual investors. As we've said before, we regard individual investor sentiment as a contrarian indicator. So after the war ended, the American Association of Individual Investors sentiment survey showed 64% of investors were bullish, up from 38% two weeks before. Nearly one in three small investors went from bearish to bullish in just two weeks. What's more, individuals who said they are bearish has been below 20% each of the past three weeks.We took it as another bearish reading.

All of this suggests that we could be facing a sell-off in the stock market over the next few weeks. But we still believe that the stock market has entered a new bull market that began last July, when corporate buying spiked. Since July, corporate buying has slowed down each time the market sustained a strong rally, keeping the market range bound for nearly a year.

Any market decline ahead could trigger more buying from companies, whose previous activities indicate they remain interested in buying at lower levels of this range. Eventually, the market breaks out of any range, and we believe that the eventual move will be upward. And when a major upturn does happen, individuals who have been standing on the sidelines will help propel the rally further.

When will the bulls finally come stampeding back in? We think the companies will answer that question when they make big cash takeovers a regular occurrence again. Right now, those takeovers clearly aren't happening, but when they do they'll signal to investors that a long-awaited bull market rally is on its way. ■

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.

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