

Has the *Bear Market* Begun?

The markets went through a lot of turmoil in the first quarter, causing some investors to liquidate their portfolios and run scared. But what does the data say?

Three reasons why this is a winners' market.

BY MICHAEL MARKOWSKI

Through StockDiagnostics.com, I have access to a proprietary computer system and software that enables me to analyze the cash flow of industry groups and indices such as the Dow Jones. This is not just any ordinary computer system; StockDiagnostics' parent company spent over \$10 million developing it. With this system, I have analyzed the aggregated data for the Dow Jones industrial components. The result? It's even more bullish than it was in January.

First, annualized free cash flow (FCF) or the cash left over after a corporation purchases its new equipment, continues to grow. FCF is the equivalent of disposable income for corporations. It's the most critical metric to monitor the stock market. When it grows, executives use it for share repurchases. When it declines, they tend to put off purchasing new equipment. These delays have a negative ripple effect on the economy. This is exactly what happened in the 12 months beginning on May 1, 2000 and ending on April 30, 2001, which coincided with the last recession and major downturn in the markets.

Prior to then, FCF had generated double-digit growth for the previous five quarters. During that run, Dow stocks increased by around 22%. Guess what? As soon as the FCF began to decline (and it continued to do so for four consecutive quarters), Dow stocks declined for the same four consecutive quarters.

Second, capital expenditures for the Dow continued to grow at a rate of about 10% or higher for the last nine consecutive quarters. Steadily growing capital expenditures have a positive ripple effect on the economy. Big companies wouldn't continue to increase capital

expenditures if they saw a recession or liquidity crisis looming on the horizon.

Third, price multiples for the Dow are closer to their 10-year lows than they are to their 10-year highs. For example, the price to Cash Flow from Operations (CFFO) multiple was most recently at 11.35. The 10-year high for this multiple was 18.86 in January 1999, and the 10-year low for this multiple was 9.82 in October 2002. The same is true for the price to sales multiple, which was most recently at 1.49. Its 10-year high occurred in January 2000 at 3.37 and its 10-year low occurred in July 2006 at 1.41.

The Bottom Line

The bottom line is that the free cash flow, revenue, and price multiples data suggest that a new bear market has not begun.

There are two drivers of the fear that was caused by the recent market downturn. They are the sharp decline in the Chinese market at the end of February and the problems that have occurred with sub-prime lenders. Believe it or not, both of these developments are bullish.

Until the recent correction, emerging markets, which include the Chinese markets, had not had a severe downturn. As a result, investment dollars, which would have usually been committed to the U.S. market by foreign investors, were instead being sent to emerging markets. Now that the risk in the emerging markets is more apparent, many of those investors will be more comfortable in investing in the U.S. Thus, I would expect to see a larger inflow of foreign capital into the U.S. market for the balance of 2007.

As for the sub-prime lenders, the result of the debacle will be higher standards for loan applicants. This will mean fewer high risk and high interest-

rate loans. If there are fewer loans made, there will be less demand for monies from lenders. The net result will be downward pressure on interest rates. Low interest rates are good for the recovery in the housing cycle and are always good for the stock market.

Finally, my explanation on why companies that are generating losses while having positive and increasing cash flows are among the best opportunities to invest in (see Biotechnology story on page 64). Many investors — especially Wall Street and its analysts — are infatuated with earnings per share (EPS). When EPS goes up, they buy, buy, buy and inevitably overpay. When losses are reported, they sell, sell, sell at prices that are way too low, and new investors avoid the company like the plague. The result is that companies that are generating positive and increasing cash flow while reporting losses do not get attention until the company becomes profitable and earnings become visible. This enables an astute investor to accumulate shares at ridiculously low prices.

A good example of this is **Investools** (NASDAQ: SWIM \$13.90). I originally recommended it to some friends at about \$0.20 per share in 2003 and StockDiagnostics recommended it in its newsletter at about \$1.25 per share shortly thereafter. The company has only had one quarter of positive EPS in its last 20 quarters. However, it has generated 13 consecutive quarters of positive and increasing CFFO, and its share price recently hit a new high of \$17.00. Investors who waited for EPS to become visible missed out. A company that looks like it could be another Investools is **NTN Buzztime** (AMEX: NTN). It has generated six consecutive quarters of positive and rapidly accelerating cash flow, and yes it has been reporting losses.