WEBB ASSET MANAGEMENT

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Monthly Commentary

SYSTEMATIC, PROVEN & RELIABLE

Commentary

Three Phases of the Bull Market

The adage "sell in May and go away" has been the wrong approach so far this year. So many traditional trading rules have been broken since the financial collapse of 2008. Why are stocks running higher when the news is so bad? Simply because companies have been beating earnings expectations amid signs of economic recovery. Though companies are announcing substantial declines in revenues and earnings, they are beating the earnings estimates, which are currently proving too low.

There are 3 phases of making money using earnings momentum.

Phase 1
Earnings are declining in absolute terms but are declining at a slower rate than market expectations. As an example, the market might expect the earnings of stock ABC to decline 50%, but earnings only decline 30%. Though a 30% decline in earnings is bad in absolute terms, earnings are declining 20 percentage points slower than expectations in relative terms and ABC stock will generally rise with the EPS surprise announcement. The greatest absolute profits are made in phase 1 as the price of ABC is usually very low given that expectations for the company are low. In phase 1 of the earnings recovery, ABC might rise 100% as the stock is re-priced from being dead to having a future. Most investors miss phase 1 as the absolute news for both the economy and ABC is still very poor.

Phase 2
It is now apparent that the economy is recovering as the absolute earnings are increasing. Earnings continue to surprise on the upside as companies are doing better than expectations as the economy slowly picks up steam. Generally, the second greatest profits are made in phase 2. Stocks rise more in absolute terms than in phase 1, but the stock price is higher so the percentage returns are lower. This is when some investors start to get on board as the news is getting better and prices are rising.

Phase 3
The economy is in full gear and there is nothing but good news. Your friends and taxi cab drivers are getting rich. Already positive earnings expectations are exceeded as businesses are firing on all cylinders. This is the phase when 'irrational exuberance' takes hold and large multiples are put on stocks as investors think the party will last forever. Interestingly, phase 3 usually has the lowest percentage profits as the denominators of stocks are already very high. In phase 3, ABC will increase the greatest absolute amount, but most like will have the lowest percentage return. Phase 3 is when most investors get on board and many start to use leverage. Phase 3 is also, the most risky phase as stock prices already reflect the 'good times' and the 'bad times' cannot be too far away.

To get the great returns, an investor must get invested early in phase 1 or phase 2 when the news is still bad. Unfortunately, most investor make the plunge in phase 3 when the news is good and the backward-looking returns are excellent.
Currently, we are somewhere in phase 1. There were many earnings surprises for the 2nd quarter even though the absolute earnings and revenues were down substantially. The following are just some of the blue-chips that had substantial decline in revenues and EPS but reported 2nd quarter EPS surprises: CP, DOW, GS, IBM, INTC, MA and MOT. Use the above scenario as a road map going forward. To make back the dollars that have been lost, it is important to be long at the bottom.

-Derek Webb

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