

May News Events Impact Stock Prices

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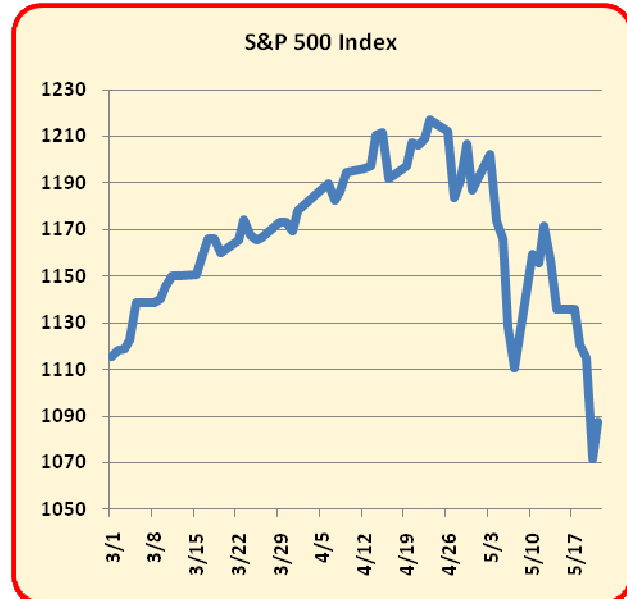
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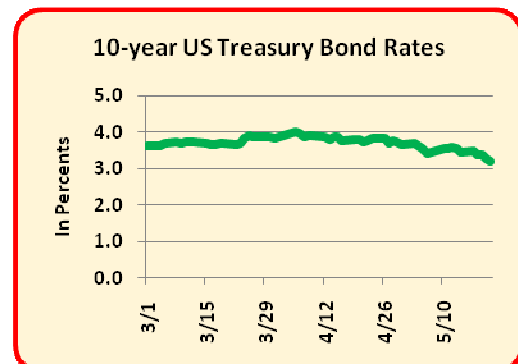
During the first four months of 2010, stock prices increased nicely. Almost in straight line. Then May came in like a lion. Hopefully, it will go out like a lamb.

Investors know that stock prices do not move up in a straight line. Even in the strongest of Bull Markets – which does not describe today's market conditions – stock prices zigzag often while continuing in one direction. But, wouldn't it be nice to see the steady increase we grew accustomed to seeing in the past four months?

In the three weeks of May, the S&P 500 Index dropped 8%, the Market Volatility Index increased 82%, the 10-year US Treasury rates dropped from 3.66% to 3.20% and crude oil prices dropped almost 19%.



Source: Chicago Board of Options



Source: Federal Reserve Board

May news reports are filled with four items. They are:

- Stock market Flash Crash,
- BP oil spill,
- Financial reform bills in Congress, and
- Greek government's debt problems.

So, let's look at the four headline stories and decide if they are likely to have a lasting impact upon the stock prices and bond yields.

Stock Market Flash Crash of May 6

For a 10 minute span of time on Thursday, May 6th, the Dow Jones Industrial Average lost nearly 700 points before recovering almost all of the loss. In the days after the so-called Flash Crash, the Securities

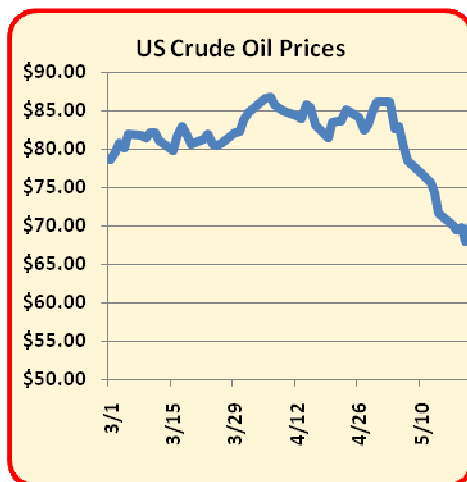
and Exchange Commission (SEC) and Commodities Futures Trading Commission (CFTC) have been searching for clues of the cause. They seized upon several possibilities only to discard each theory after further research. Their conclusion - no one single event caused the drop.

But what does the Flash Crash mean to stock market investors? Is it a foretaste of new volatility? Is it a preliminary sign of a longer duration drop? Nothing the investigators find – or didn't find – will help answer these questions.

The Flash Crash dramatically points out that the majority of daily market activity comes from short-term traders. Individual day traders, hedge funds and high-volume traders use computerized models to buy and sell the same exchange traded fund (ETF) or index mutual fund several times a day. Short-term traders are relatively small by number when compared to the millions of long-term investors. However, their actions are adding to market volatility.

The Flash Crash is a reminder that as long-term investors our attitude and thinking should be to ignore the daily fluctuation of stock markets and keep our eyes affixed to long-term economic trends, stock performance fundamentals and astuteness of company management.

BP Oil Spill



On April 29th, the oil well exploded at Transocean's Deepwater Horizon drilling platform. The immediate result was death of 11 workers and a fire that eventually consumed the entire floating rig. The current result is a month-long saga by British Petroleum to stop the oil spewing from the wellhead. The eventual result will likely be decades of clean-up efforts, many years of sluggishness in Gulf Coast tourism and its shellfish/fishing industry, and permanent damage to the ecosystems in the Gulf.

Despite the environmental disaster that will last for decades and regional economic crisis that will last for several years, the BP oil spill will not have an enduring impact on stock prices and bond yields, in my opinion.

Financial Reform Bills in Congress

Personally, I encourage efforts to require regulation of credit swap derivatives and trading through a public exchange. Also, I agree with former Fed Chairman Volcker's push to separate investment banking from commercial banking, even though the provision will probably not survive.

Two bills have been passed, one by the Senate and one by the House. The final law will come from joint Congressional committee deliberations, spelled c-o-m-p-r-o-m-i-s-e. Within two weeks, the bill will be finalized, passed and signed into law. Then the real work begins; company executives deciphering the law's long-term impact upon their businesses, and how to mitigate the damage to profitability. The stock prices of large financial companies will rise from their present levels. Their price increases will come because the uncertainty that presently exists is lifted. The near-term price increase will occur even though many financial companies' profitability over the next couple of years will be reduced slightly.

Within two weeks, most of the stock price decline caused by financial reform legislation on will be gone.

Greek Government's Debt Problems

In April, the Greek government had to admit that it had been cooking its books. For years, it had understated the amount of loans (Greek government bonds) it had outstanding and overstated its tax revenue. The confession came because Greece was having problems borrowing more money in the bond market to repay its loans coming due.

Greece is part of the European Union or EU. When initiated, the EU's vision was that all countries would be regulated to prevent problems like what Greece is experiencing. And, if such problems occurred, all other EU members would immediately come to the rescue of the economically-troubled country.

Like a drop of gas landing in a pool of water, the Greek debt crisis spread a thin layer of doubt about all of Europe's economic health. To complicate matters, other European countries balked at lending Greece the money needed to pay its debts and bonds as they matured. Some observers even speculated that the entire EU structure – as well as its common currency, the Euro – would not survive. Under the leadership of Germany and France, the Greek government received sufficient funds to retain their liquidity and pay bonds as they mature. However, many economic experts viewed the EU bail-out as merely deferring the problem until a future date.

The current EU bail-out might be a Band-aid approach, deferring a real solution to some future date. However, by that day of reckoning, I expect the European economies will be much stronger than they are today. And this is a good thing. I believe the crisis was averted and will become a non-event soon.

Optimism

While the four headlines cited at the beginning of the article dominate the news, several other stories are being ignored or their importance is being diminished. Here is a sample.

- This morning, the National Association of Realtors reported a 7.6% increase in existing home sales in April.
- The Wall Street Journal reports today that mortgage loans are currently near a 50 year low. My informal Internet survey of Twin Cities' mortgage rates (30 year fixed, 0 points, 20% down) average 4.90%. The BankRate.com national average for the same type of loan is 4.96%.
- Minnesota's Department of Employment and Economic Development reported on May 20th that the state's unemployment rate dropped to 7.2% in April. Also, they report 10,200 jobs were added in the state during April.
- US Consumer Price Index – Core is at 1% in April. A TD Bank Financial Group special report dated May 18th projects that inflation will remain at 1% during the second half of 2010. Also, they project a slow rise from 1% to 1.5% by the end of 2011, as employment and housing prices stabilize and improve.
- Several individuals have furnished me with anecdotal stories of higher backlog, sales growth a recovering business environment during April and May.

Will stock prices continue to decline? It's unlikely. But I do not see stock prices increasing significantly during the summer months. Hopefully, the increases will come this fall.

Will bond yields continue to drop? Probably not, it should stabilize at pre-May levels soon. The drop is due to European investors seeking a temporary safe haven for their money.