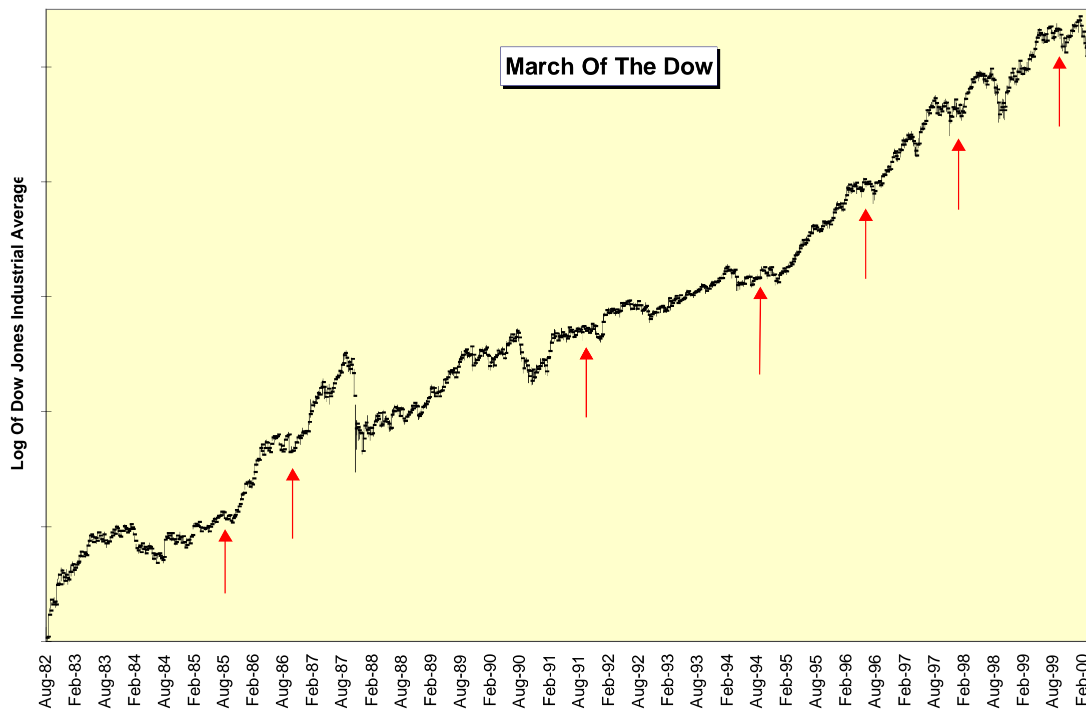
Diamonds Are A Boy's Best Trend

It sounds like a bad day in pop psychology: Are you a spider, a cube, or diamond? Cognoscenti of exchange-traded investment trusts -- and aren't we all? -- will recognize these objects as the Standard & Poor's Depository Trust, the NASDAQ 100 Trust, and the Dow Jones Industrial Average Trust. Over the past year, the venerable DJIA became the Rodney Dangerfield of the index world. Not only couldn't it get no respect, it didn't deserve any, either.

Traders must hold well-researched opinions with great conviction, but must be prepared to turn 180° within seconds when the world changes. After all, you always can get another set of opinions, but opportunities disappear quickly when ignored. The explosive rally in the Dow this past week constituted one of those moments when it is best to buy first and ask questions later. While it is possible this was a sucker rally doomed to reversal, experience indicates a move like that with no apparent trigger signals the start of something big, very big. You'll find out why later. Right now, there are 30 giant stocks charging at you with a banner reading "Old Economy My A--."

Sit Around And Surge

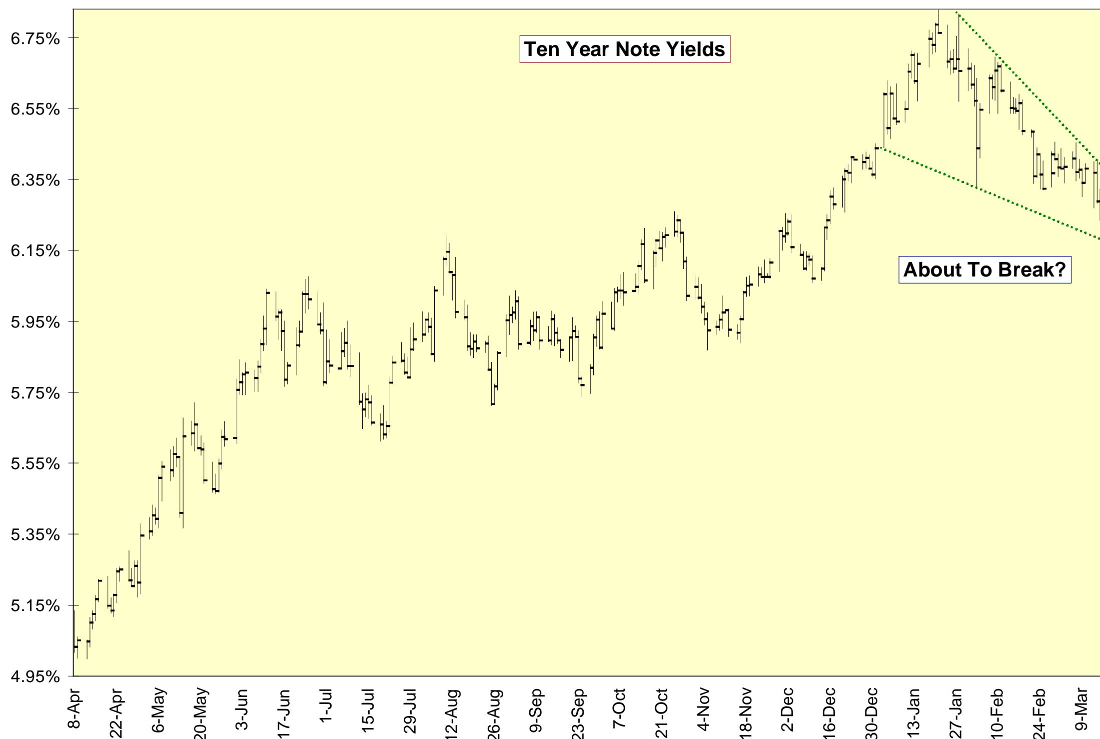
It would not be at all unusual for the Dow to surge after a prolonged period of consolidation and negative action. The graph below highlights some of these periods since the long bull phase began in 1982.



Most of these surges came either in anticipation of or in reaction to a global upsurge in liquidity. The 1985-1986 market was a reaction to the Plaza Accord to drive down the dollar, while the 1987 surge was a reaction to the Japanese attempt to drive down the yen. The 1992 pop came after aggressive Fed loosening, while the 1995 rally began after the Fed stopped raising rates and the Japanese once again tried to drive down the yen. Subsequent rallies in 1997 and 1998 came after the Fed had to defer to the various and sundry global crises.

We are now nearing the end of another Fed cycle of tightening. Longer-term interest rates are now falling, and only partially in response to the Treasury's various bungled attempts at retiring government debt. No

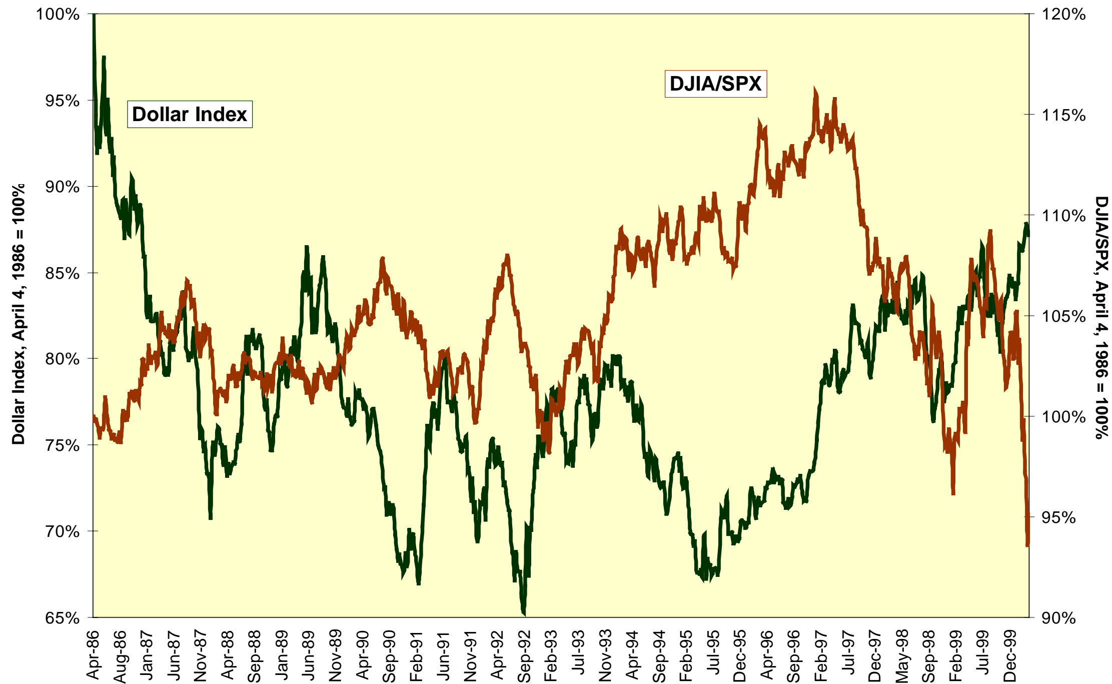
surprise here: This page has been skeptical of incipient inflation for months despite various commodity price hiccups. The chart on ten-year note yields is poised to move sharply lower in weeks to come.



Another subtle, important, and possibly dangerous in the long run factor is the continued absence of fear. The NASDAQ just completed its third 10% correction of the year by the middle of March, but with the P/E of the composite and of the NDX standing at 528 and 154, respectively, on March 17, even the most wild-eyed techno/bio/connecto bulls should start to wonder. Not so with the mundane Old Economy stocks; we noted last week the P/E of the Dow Transports was a cheap 7.25; it is now a less-cheap 7.58. The Industrial's P/E is now 24.64. Now that the NASDAQ proved interest rates, earnings, or even revenues don't matter, other indices are likely to follow. Previously unthinkable P/Es for household names may be just around the corner in what possibly may be a historic revenge of the value nerds.

Let's not mince words here. Our good friends at the Fed are not -- repeat, not -- going to torpedo a wonderful economy by raising rates too far. The stock market bubble is confined more to twenty super companies with dominant technical franchises (Sun, Cisco, JDS Uniphase) than to the rank and file, and these stocks have demonstrated their immunity to whatever has been tossed their way short of a thermonuclear device. Once the price of crude oil starts to break, and it will by summer's end, the latest Chicken Little inflation scare will be over.

The key behind the coming Dow rally will be a weakening of the dollar on foreign exchange markets as the interest rate hikes end. The Dow has a huge foreign earnings component, and a weaker dollar will help Caterpillar, McDonald's, and Coca-Cola, amongst others. Since 1986, the relative performance of the Dow against the S&P has been inverse to the dollar's strength.



How high is high? A breakout over the January high of 11,700 measures to 14,600, and that figure could be reachable by year's end. A quick perusal of the Dow's thirty components yields only a few uninspiring charts, principally Philip Morris and the recently-eviscerated Procter & Gamble. Philip Morris, priced more as a defendant than as an operating company, is wildly cheap; its Kraft General Foods unit is likely worth more than the parent company alone. And, as for P&G, people will still use toothpaste and laundry detergent, although perhaps not as often as they should.

Buy Diamonds. If nothing else, they're more attractive than SPDRs.