Sour Notes From The Heavy Metal Band

In the words of Stephen Ambrose, the best laid plans of mice and men can often get you hosed. Or something like that. Just one week ago, I questioned whether the market was truly as bad as it looked, and concluded that we'd probably test the September low before moving higher on the weight of good economic news. Fancy, fancy, fancy.

Instead, we jumped higher not on any economic news, but on some better than expected earnings from Applied Materials and Dell Computer. Actually, the economic news was mixed at best, particularly in the recently strong housing sector, and interest rates at the investment horizon are threatening to move higher.

But the disconnection between the economy, the market and earnings has been pronounced in recent years due to the dominance of the technology sector within the senior indices. Even after the pounding of the last two years, the technology-related sub-indices of the S&P 500 still account for 18.9% of the index' value, and these stocks routinely combine for more than 30% of average daily trading volume. But, are these issues economically sensitive the way that old-line manufacturing is, or are they dependent almost entirely on a combination of new product cycles, corporate capital spending and their own production and inventory over-capacity problems?

S&P Sub-Index	**Weight**
Pharmaceuticals	9.48%
Banks	7.00%
Diversified Financial Services	6.92%
Integrated Oil & Gas	5.49%
Industrial Conglomerates	4.27%
Systems Software	**3.87%**
Semiconductor	**3.82%**
Integrated Telecommunication Services	**3.82%**
General Merchandise Stores	3.26%
Computer Hardware	**3.15%**
Soft Drinks	2.49%
Movies & Entertainment	2.24%
Multiline Insurance	2.06%
Electric Utilities	2.04%
Household Products	1.95%
Aerospace & Defense	1.87%
Health Care Equipment	1.55%
Home Improvement Retail	1.50%
Packaged Foods	1.44%
Networking Equipment	**1.27%**
Tobacco	1.23%
Telecommunications Equipment	**1.15%**
Data Processing Services	**1.13%**
Property & Casualty Insurance	1.10%
Biotechnology	0.95%
Diversified Chemicals	0.87%
Life & Health Insurance	0.78%
Consumer Finance	0.78%
Department Stores	0.75%
Industrial Machinery	0.70%
Semiconductor Equipment	**0.68%**
Broadcasting & Cable TV	0.67%

Publishing & Printing	0.66%
Automobile Manufacturers	0.66%
Restaurants	0.65%
Managed Health Care	0.62%
Health Care Facilities	0.60%
Health Care Distributors & Services	0.57%
Oil & Gas Exploration & Production	0.56%
Oil & Gas Equipment & Services	0.56%
Technology Subtotal:	**18.90%**

It's Not The Economy, Stupid
The question presupposes the answer. Consumer confidence can rise and fall with only a loose connection to that ultimate barometer of consumer sentiment retail sales, and retail sales themselves may or may not translate into higher earnings and higher P/E's. Incredibly, the statistical relationship is that the stock market leads consumer expectations, not the other way around.

But in any event, I might get out there and act like the proverbial drunken sailor, but that should do Brown-Forman a lot more good than it will do for Cisco Systems, Juniper Networks, Oracle, or any other technology firm that makes things I cannot buy directly. I can do well and they can do poorly, or vice versa, and that helps explain much of the disharmony between the senior averages and the general economy.

Is Copper A Stopper?
No such disconnection exists, however, between the economy and base metals. A funny thing happened on the way to the recovery in London last week: All of the industrial metals traded on the London Metals Exchange, copper, zinc, aluminum, tin, nickel and lead, had what are unmistakably chart breaks. Let's take a look at zinc, used in the manufacture of brass and in galvanic coatings. It broke a support line last week.

Lead, often a co-product of zinc mining and used in car batteries, plumbing, solder and bullets, is looking just as bad. The picture is the same for the other base metals. To add to the puzzle, most metals tend to have an inverse relationship with the U.S. dollar, and the greenback definitely has been on the defensive in recent weeks.

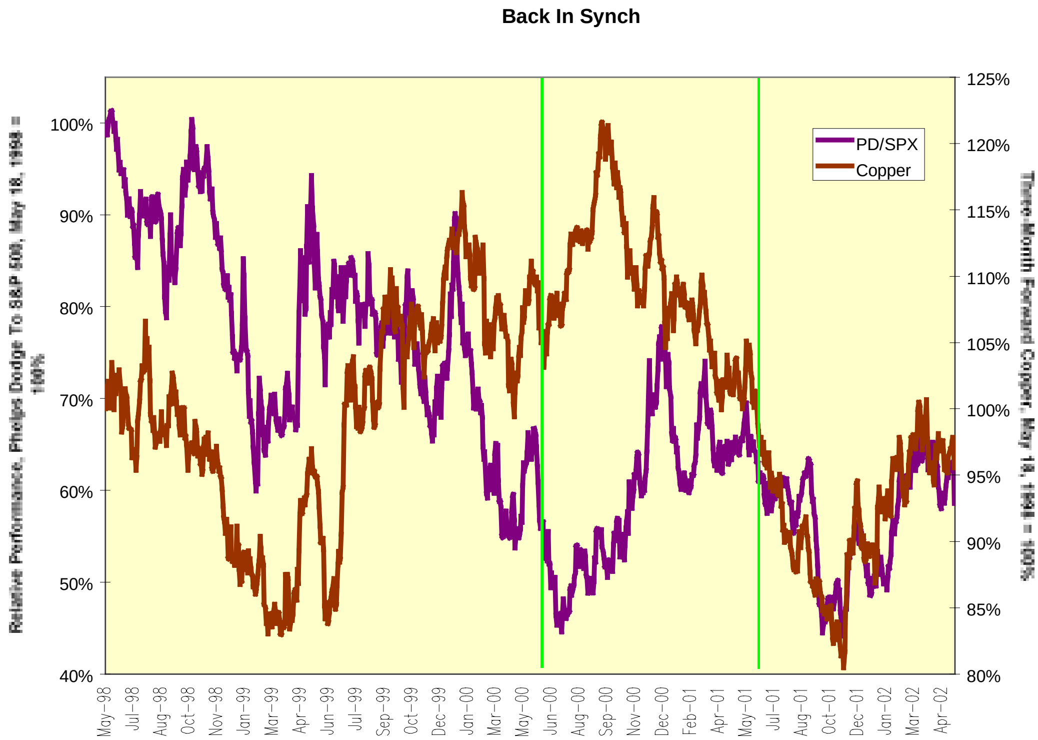
Get The Lead Out

So, the multibillion-dollar question now becomes whether an economic recovery truly can be healthy if those unglamorous relics of the Bronze Age are weakening. The answer is probably not, and we can be comfortable for the time being that no inflationary pressures are showing up in these sensitive commodities as a result of a weakening dollar and low short-term interest rates.

But, as many have noted in the past, stocks can do quite well in an economy that is growing slowly without inflation as this condition keeps both costs and interest rates low and creates an environment conducive for corporate consolidations in industries plagued by over-capacity. Translation: Watch for a wave of technology mergers that will rival the consolidation seen in the oil service industry in the 1980s after its bubble burst. Firms such as Baker Hughes, Cooper Cameron and Halliburton all swallowed up competitors. How many optical networking firms do we really need?

Copper Turns Green. So Can Your Account

Regardless of the economy's course or whether the gyrations of the tech sector continue to distort the senior averages and their link to the economy, you can capture the link between copper prices and a leading copper miner, Phelps Dodge. After a brief disconnect in 2000-2001, the movement of the stock relative to the S&P 500 and copper prices mirror each other closely again.



Right now, the weakness in copper argues for selling Phelps Dodge against the S&P 500 in equal-dollar quantities. If and when the economy firms and copper prices head back north, reverse the trade. Is this "fancy?" Yes, but once single stock futures are launched, it will become a whole lot simpler.