

9/03/2010

MF Global Daily Report

# U.S. Stock Index Outlook

## Outlook:

Stocks are expected to find support on breaks. Last week's rally was extremely impulsive, and argues for the purchase of the first healthy sell off. Look to buy SPU at 1082/85 and expect a move toward 1125/1150. A break under 1070 would be a sign of weakness. The market has seen a string of bullish surprises on the economy, and the rally is likely to cool the heavy pace of liquidation from mutual funds. Companies have been slow to cut their earnings outlook, so there is a window for investors to feel more confident about the profit outlook and focus on cheap valuation. M&A continues to flow with Goldcorp announcing a purchase of Andean Resources for C\$3.6 bln Friday. One monitor also showed relative strength in insider buying to insider selling late last week. A sustained rally faces a few hurdles this week, as TXN holds a mid quarter update and NSM posts profits on Thursday. Both companies are vulnerable to disappointment given INTC's recent profit warning. Additionally, the trade is likely to see soggy August sales figures from Taiwan fabs TSM and UMC. The sluggish news should be priced, however. Look for SPU to range between 1080 and 1126 this week.

## Support/Resistance

	SPU	NDU	DJU
R2	1122/27	1891	10600
R1	1112	1880	10510
S1	1091	1851	10365
S2	1082	1841/25	10280/210

## Perspective:

The macro calendar is light this week and will cause the trade to focus on the corporate calendar. There are a handful of profit reports, company events, and conferences, which will shed light on the outlook for corporate profits. With the end of the quarter around the quarter, companies could use the conferences to adjust guidance. Looking at profits, CIEN and TITN will get a look or two on Wednesday, and MSN releases numbers on Thursday. The trade will be very interested in spending on telecom equipment (CIEN) and the health of the chip sector (MSN). TITN sells Ag and construction equipment, DHR holds an analyst conference on Wednesday, and TXN has its mid quarter update on Thursday. The trade will also be watching for August sales numbers from chip foundries (UMC, TSM, and ASX). On conferences, Barclays holds a back to school conference Tuesday and Wednesday. PM, PEP, TAP, PG, and KO are a few names presenting. Citi has a technology conference, where MSFT, MOT, CREE, GOOG, DELL, and BRCM present. There is also a Credit Suisse transportation conference with TRW, UNP, CSX, and GRW. The strength in the ISM manufacturing survey and lack of negative guidance from the Morgan Stanley industry conference has supported the market. However, the market remains jittery about the profit

outlook as INTC guided its revenue lower and the ISM non-manufacturing index showed a continued slowdown in growth. Lastly, the trade will keep an eye on Washington. There is growing movement for some type of stimulus plan. The Democrats are desperate to get the economy moving and show they are pro-growth. The President seems to be lapsing into targeted tax cuts, infrastructure spending, and other buzz words which poll well in setting policy. Lack of meat in the plan will be a disappointment to stock bulls. Signs that tax rates will be unchanged, especially on upper marginal rates and capital, will support prices.

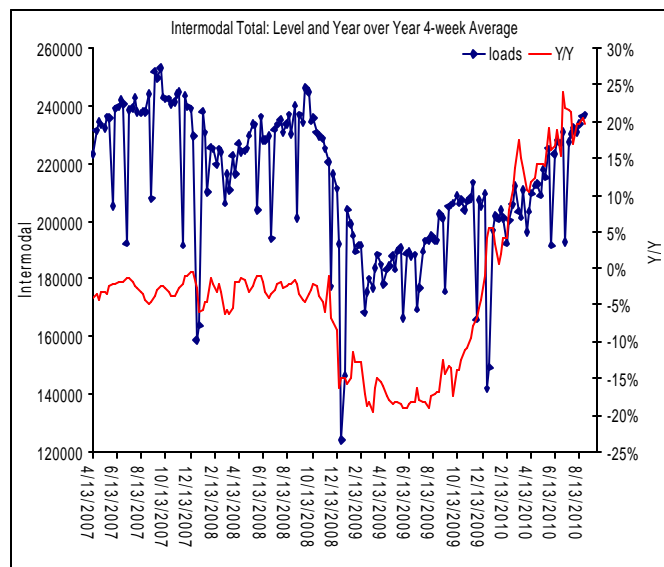
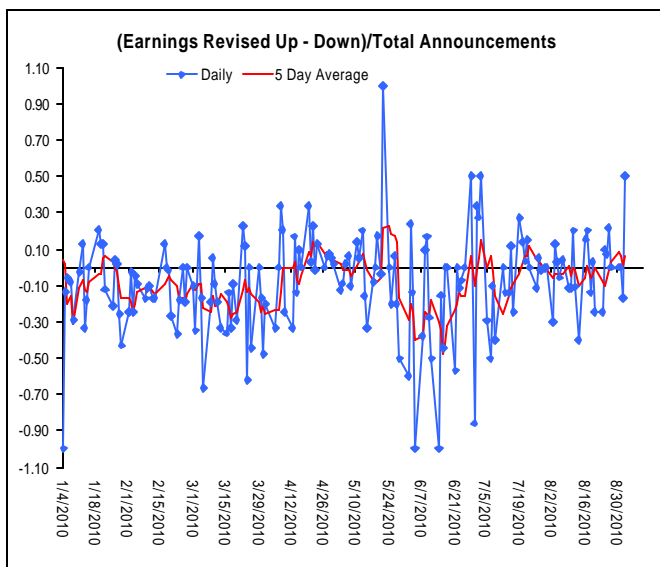
**Earnings:**

Expected earnings growth for the S&P 500 continues to be shaved, but the drop is not enough to pressure the market given the recent sell off from the spring high. Q3 and Q4 profit growth for the S&P 500 is still expected to rise 24.2% y/y and 31.9% y/y respectively. The table below displays the trend in profit growth overall and by select category. Notice that IT shows the biggest cut of the three sectors presented and the transport sector is unchanged.

Select Changes in Profit Estimates

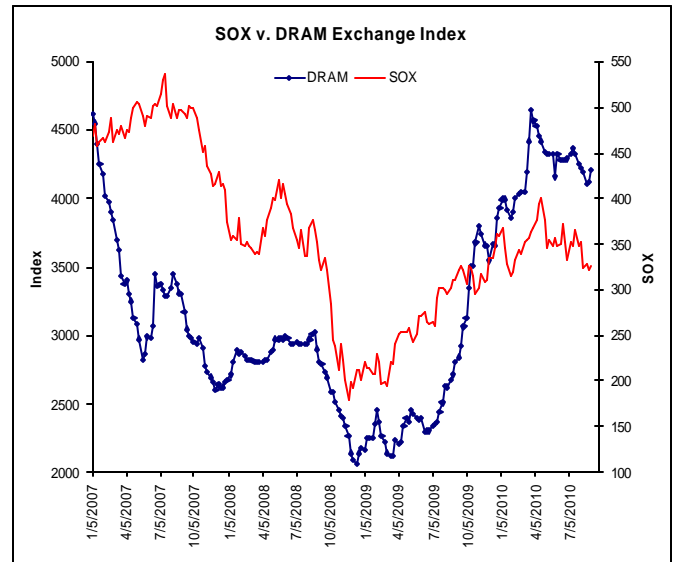
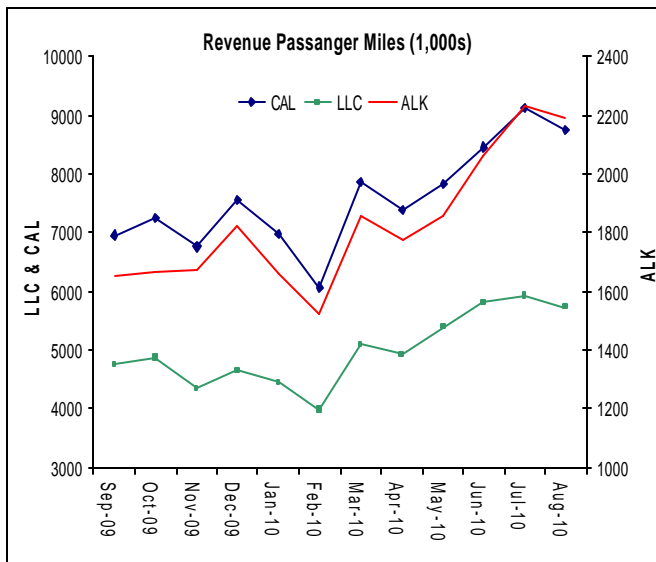
	S&P 500		Consumer Disc		Info Technology		Transport	
	Q3	Q4	Q3	Q4	Q3	Q4	Q3	Q4
<b>8/6/2010</b>	24.80%	32.40%	21.20%	9.90%	38.30%	18.40%	55.10%	29.20%
<b>9/3/2010</b>	24.20%	31.90%	20.50%	9.70%	37.40%	17.30%	55.10%	29.20%
<b>Change</b>	-0.60%	-0.50%	-0.70%	-0.20%	-0.90%	-1.10%	0.00%	0.00%

Changes in profit guidance have been limited in recent weeks, but companies are tending to hold there profit guidance firm or even pushing numbers higher. The graphic displays the difference between upward and downward revisions. The five day moving average is holding firm.



The transportation industry appears to be showing solid growth. Weekly intermodal numbers continues to show sequential strength, and are slowly approaching pre-crisis levels. The year over year growth rate also remains elevated, but base effects will dampen the growth rate going forward. The data set argues

for rail names to hold their profit guidance steady. The graphic below displays the trend in airline revenue passenger miles. More companies will be releasing numbers in the coming days, but the trend in activity is firm and consistent with improved travel demand.

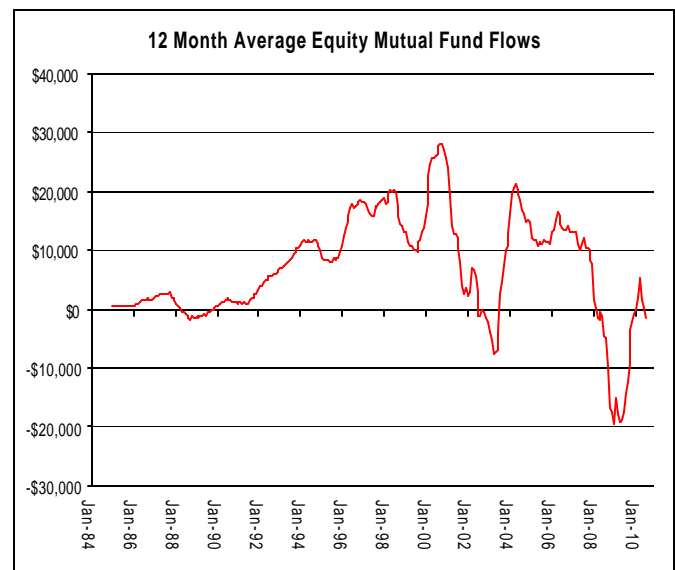
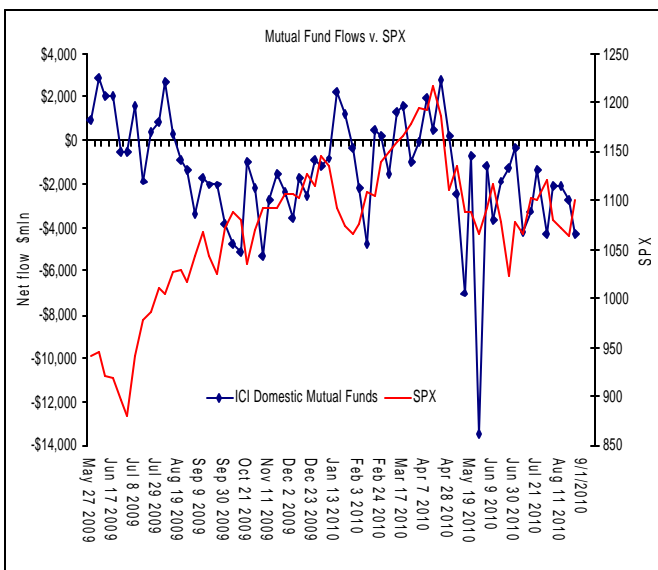


Semiconductor stocks have rebounded in recent days helped by a stronger tone in memory pricing. The Asian trade press has been filled with downbeat stories about notebook demand and a pushing out of business. The slowdown has been well publicized and is highlighted by INTC's move to cut revenue guidance. The market is sober about the risks of TXN cutting its sales guidance, but the stock was able to bounce off the \$23 area last week. Over the last year, the stock has ranged between \$22.25 and \$27.50. At writing, TXN was trading at \$21.18. For Q3, TXN is expected to earn 69 cents a share on sales of \$3.694 bln. Going future, the trade is pricing weak sales from UMC and TSM given their stock price action in August. Specifically, TSM broke from over \$10.50/share in late July to a low of \$9.30 on August 31<sup>st</sup>. Like TXN, it was trading at the bottom of the 52 week trading range. The graphic above displays the relationship between the DRAM Exchange index and the SOX index. Notice that the DRAM index is making signs of a bottom. The pattern could be consolidation from the 2010 high. If true, the pattern argues for a run higher in prices and new leg higher. Chip stocks are not prepared for higher chip prices and a rebound in demand. A rising DRAM price would be consistent with a rebirth in electronics demand. It is possible that demand patterns in H1 were stronger than anticipated and the normal boost in Q3 did not pan out. Concerns over slower growth in the wake of China's policy to curb the housing market and the European financial crisis created a decline in demand and caught the trade off balance, but some of the weakness may have been linked to distorted seasonal patterns.

#### Investment flow:

Investors are poorly positioned for a stock rally. Weekly mutual fund data shows a persistent level of selling in recent weeks. Domestic equity mutual funds have not seen an inflow since April 28<sup>th</sup>. Between May 5<sup>th</sup> and August 25<sup>th</sup>, \$56.16 bln has flowed out of U.S. equity mutual funds. The graphic below left displays the relationship between mutual fund flows and stock prices. Notice the correlation between the two series has been strong since April, but there was less correlation during 2009. The AAII bull poll touched 20 a few weeks back and is at a level consistent with extreme pessimism. The negative sentiment toward the market is confirmed by the persistent exit of cash from the equity market. The

outflow of cash from the market coupled with the low sentiment reading is a bullish contrary indicator. A reduction in mutual fund liquidation will allow the market some room to rally. It is possible the rally and improved economic news to expectations slows the outflow. More broadly, the outflow from mutual funds in the wake of the credit crisis was greater than the tech melt down and the stock market crash in 1987. The movement of money into ETFs may have something to do with the outflow, but there is definite movement out of the market. Note that the market has seen a pick up in M&A activity. There were \$55 bln in announced deals in August. The level of activity was more than double last year. The average premium came at a 41.4%, which suggests the market has value. M&A volume was very weak in September and October 2009 at \$37 bln and \$27.5 bln respectively. The matching of mutual fund sales against a pick up in stock buybacks and M&A is a bullish contrary indicator. Corporate money is buying and retail is selling.



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