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The good parts of bad news and a moving target...and why the stock market is so volatile

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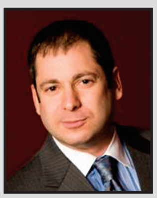

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At this point in the upward slope of the stock and housing markets, it isn't too difficult to blame investors for being skeptical of the improved economic statistics; maybe even downright paranoid. But while we've been hit with news that's been overwhelmingly negative for the last 2 years, we must be sure to keep our ears, eyes, and minds open to the eventual good news that we'll surely have again. Otherwise, investors may miss out on the recovery; a mistake that is sure to permanently lock in losses now and in the future.

Ultimately, bad news is really the generator of good news. Before we go any further, this article will make sense only if you believe the economic world we live in is cyclical; meaning, history is a repeating mechanism.

A weak economy gives way to an environment of low inflation AND low interest rates.

Notice the precipitous drop since July of 2007 in commodities; oil, gold, corn, copper, etc? Notice that short and long term interest rates are at or near historic lows? And how about all of that excess manufacturing capacity and labor? This was the same environment that launched a bull market in 1991. It is doubtful that interest rates will rise due to lowered inflation expectations for the foreseeable future and so much availability of labor.

A seriously injured financial sector will give way to a major wave of consolidation.

Just look at the consolidation in the banking sector; from over 14,000 banks pre 1990 to a little over 8,000 currently. Investors profited handsomely between the end of 1991, the end of another banking crisis, to the end of 2007. Remember Manufacturers Hanover, Shawmut, First Union, Fleet, and most recently North Fork? Like any other commodity, fewer players typically means that institutional money managers are forced to buy more shares of the remaining entities. I expect this trend to continue, even accelerate, over the near term. We've seen a rise in mergers and acquisitions in many sectors of the economy over the last few months; technology, financial, pharma, etc. This is a key way in which industries repair themselves and improve their efficiencies.

Lower housing prices, single family homes in particular, give way to a new housing bull market in terms of price and activity.

For the first time home buyer, housing affordability is the best it's ever been. Do you think no one will ever buy a house again?! Once activity picks up a little, it becomes a self fulfilling prophecy. Houses are off the books of the banks, housing inventory drops, housing related jobs once again need to be filled, and durable goods orders (think washing machines, refrigerators, and furniture) rise. We're witnessing this now. This brings us to the next item, Gross Domestic Product (GDP).

Low and/or negative GDP gives way to rising GDP.

Do the media ever remind anyone that GDP goes down AND up? Hey, I'm not at all for any kind of censorship whatsoever. But if all one hears is negative news all day and night, like the last 2 years, one may become a little slanted toward an overly negative view of the future. Negativity and optimism are like a pendulum; often too far in either direction with very little time in the middle. Today, economic statistics are clearly improving and the stock market has risen. GDP for Q2 of '09 was revised higher. In reality, it simply wasn't as negative as we thought. Q3 includes "Cash for Clunkers" and may offer the best proof that the Great Recession has ended; a positive reading on GDP.

Cost cutting by surviving corporations gives way to increasing earnings per share and healthier balance sheets.

Rising earnings per share and healthier balance sheets causes what? That's right, increasing share prices. One can argue that cost cutting can only help for so long. True enough, but when you start from a very low starting point like we had this past March, valuations have a lot of room to grow.

Selling by weak and uncommitted share holders gives way to cheap stock prices.

What happens to cheap stocks, being fundamentally sound of course? They go back up. Often, they go on to make new highs – again and again.

A state of too much inventory leads to inventory re-stocking.

Recessions always have a recurring theme; they start with too much inventory of almost everything. Corporations react by halting production. Once inventories are sufficiently reduced, a new cycle of re-stocking inventory kicks in…and it jump starts the economy. Can you thing of a recession that didn't end that way?

While none of the above is guaranteed to happen, recessions have always happened this way nevertheless. Well, all of this is happening again. Its time to start believing that we've turned a corner.

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