

October 26, 2005

# Stock Market Report

## Market Analysis for Period Ending Friday, October 21, 2005

This document presents technical and fundamental analysis commonly used by investment professionals to interpret direction and valuation of equity markets, as well as tools commonly used by economists to determine the health of financial markets and their impact on the domestic United States economy. The purpose is to provide a synopsis of equity markets from as many disciplines as possible, but is in no way an endorsement of any one mode of study or source of advice on which one should base investment decisions.

Definitions of terms and explanations of indicator interpretation follow the charts in the Endnotes section.

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### Technical Trends

Figure 1 presents price trends and daily volumes for the New York Stock Exchange and Nasdaq Composite Indices.

The New York Stock Exchange Composite Index (NYSE Index) closed Friday, October 21 at 7254.49, reaching its end-of-2004 level. The index has fallen 5.3 percent since its September 9 high of 7663.82.

The National Association of Securities Dealers Composite Index (Nasdaq Index) closed Friday, October 21 at 2082.21. The Index is down by 4.3 percent since the beginning of the year and 6.1 percent since this year's high reached on August 2 (figure 1).

Figures 2, 3, and 4 present some technical indicators commonly cited by stock market analysts.

On October 21, the relative strength index for the NYSE Composite had a value of 36.9 percent, in neutral territory (figure 2, upper panel). The number of stocks making new 52-week highs declined throughout October while the number of new lows increased (figure 3, upper panel). The middle panel shows that momentum (overbought/oversold oscillator) was in oversold territory during the past month. The Market Breadth indicator continued to decrease during October and followed the Index closely, implying a widespread market decline (figure 3, bottom panel).

The relative strength index for the Nasdaq Index had a value of 46.1 percent on October 21, in neutral territory (figure 2). The number of new highs continued to drop during October while the number of new lows rose (figure 4, upper panel). The momentum indicator remained in oversold territory throughout October (figure 4, middle panel). The Market Breadth indicator continued to diverge from the Index, suggesting that the trend is not widespread (lowest panel, figure 4).



## Volatility

Indicators of market volatility are shown in figure 5.

The Chicago Board of Options Exchange (CBOE) provides daily measures of volatility for the S&P 100 (VIX) and for the Nasdaq 100 (VXN). Both indices rose during October.

Put/Call ratios appear in figure 6. Monthly data are shown from January 1997 through August 2004.

The CBOE individual equity put/call ratio was 0.59 in September, at a neutral level close to territory normally identified as bullish. The S&P 100 put/call ratio moved during September right above the neutral level into territory normally identified as bullish.

## Sector Performance

Figure 7 compares the performance of the various economic sectors within the S&P 500 as well as other international and style indices.

As of October 21, eight of the ten S&P 500 economic sectors recorded negative returns since the start of the year. The energy sector, which had the largest average returns over the past five years, has also been leading during 2005 with a return of 20.72 year-to-date. Telecommunications, the worst performer between 1999 and 2004, has seen the largest declines so far, together with Consumer Cyclical and Materials (figure 7, top panel).

Three of the four geographic indices recorded a positive return year-to-date. Germany's DAX rose 13.7 percent, the U.K.'s FTSE 100 is up 6.8 percent and Japan's Nikkei 225 14.9 percent. The Wilshire 5000 dropped 1.5 percent (figure 7, middle panel).

All four Russell Style Indices recorded a decrease year-to-date. The Russell 2000 Small-Cap Index fell 2.9 percent, the Russell 1000 Value Index dropped 1.9 percent, the Russell Large-Cap Index is down 1.5 percent and the Russell 1000 Growth Index decreased by 1.3 percent (figure 7, bottom panel).

## Valuation

Figure 8 displays historical and current price-earnings ratios for the S&P 500 economic sector groups described above in the top panel, and analyzes earnings growth in 5-year, 3-year, and 1-year increments for each sector in the bottom two panels. Figure 9 graphs the current and previous earnings forecasts for several calendar years in the top panel, and lists the current and previous growth of earnings forecasts for each S&P 500 sector in the two tables. Figure 10 shows three measures of historical and future valuation: historical PE ratios in the top panel, forward and trailing PE ratios using analysts' estimates of operating earnings in the middle panel, and strategists' two-year forecasts of earnings growth in the lower panel.

The price-earnings ratios in 2005 continue to resemble past years' observations for most S&P 500 economic sectors. The PE for the materials sector is at its low, 12.9 in October. The consumer cyclicals sector has the highest PE ratio of 32.3. The PE for the telecommunication sector dropped from 38.4 in September to 19.3 in October. (figure 8, top panel).

The macro projections from strategists for the growth of earnings for the Standard and Poor's 500 index over the next two years have been revised upward to a positive 11.0 percent in the third quarter of 2005. (figure 9).

### **Breadth of the S&P 500**

During 2004, prices rose from a year ago for 79.5 percent of stocks in the S&P 500. In the second quarter of 2005, 64.0 percent of S&P 500 stocks were above their second quarter 2004 levels (figure 10, middle panel). The year-on-year median price percent change was negative for four deciles in the second quarter of 2005 (figure 10, top). The median price earnings ratio in the second quarter of 2005 declined for all deciles except the lowest one. The median price earnings ratio remains above the historical average price earnings ratio of 14.4 for seven deciles (figure 10, bottom).

### **Comparative Returns**

The earnings-price ratio decreased to 4.0 percent in the third quarter of 2005 from 5.4 percent in the second quarter of 2005. The dividend-price ratio, an indication of the yield investors receive through dividends by holding stocks, remained at 1.8 percent during the third quarter of 2005, substantially below the bond rate (figure 11).

The operating profit payout rate for nonfinancial corporations has fallen from 42.8 in the first quarter of 2005 to 37.2 in the second quarter (figure 12, lower panel).

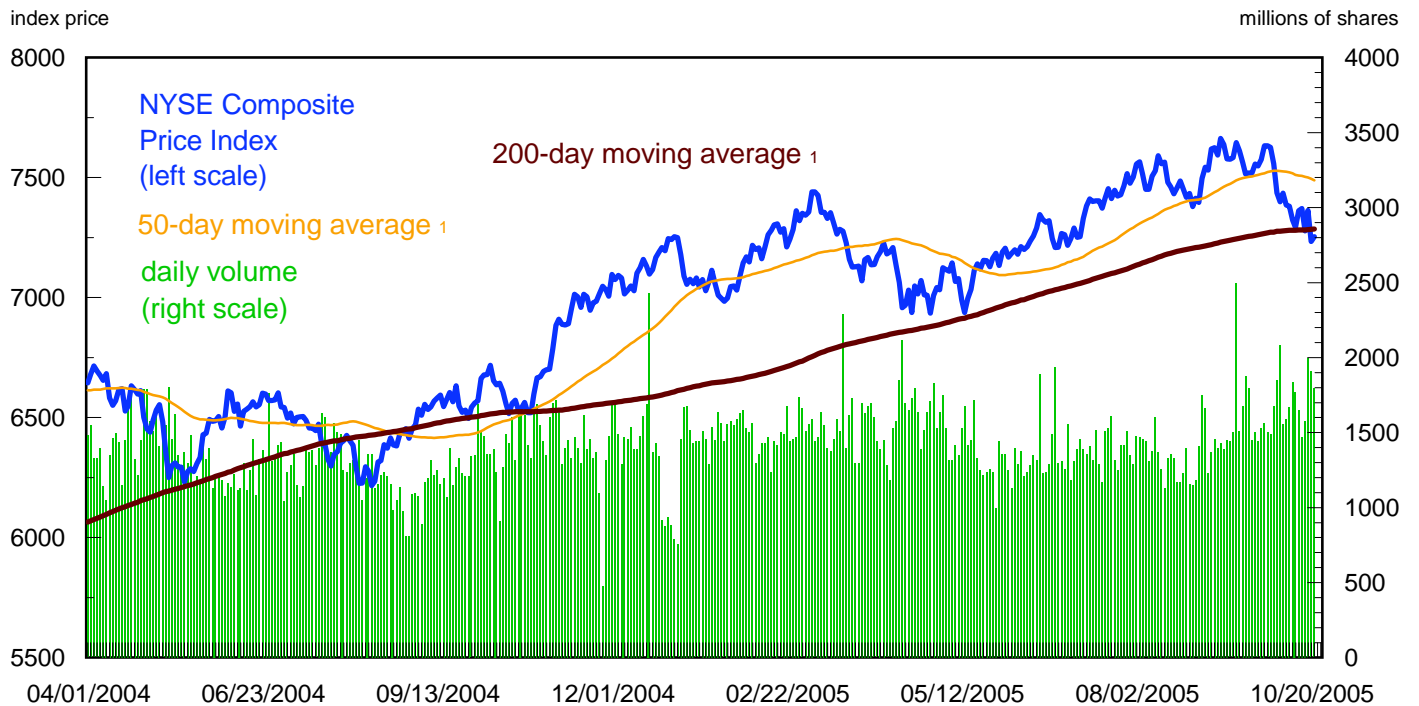
Moody's upgraded a slightly higher dollar amount of Investment Grade Securities than it downgraded in September. A greater number of Speculative Grade Securities were downgraded than upgraded (figure 14, top and middle panels). The default rate on junk bonds increased to 3.7 percent during September (figure 14, lower panel).

The Stock Market Report is now available to the general public. The current issue, as well as previous editions, can be found at our public website, <http://www.bos.frb.org/economic/smr/smr.htm>.

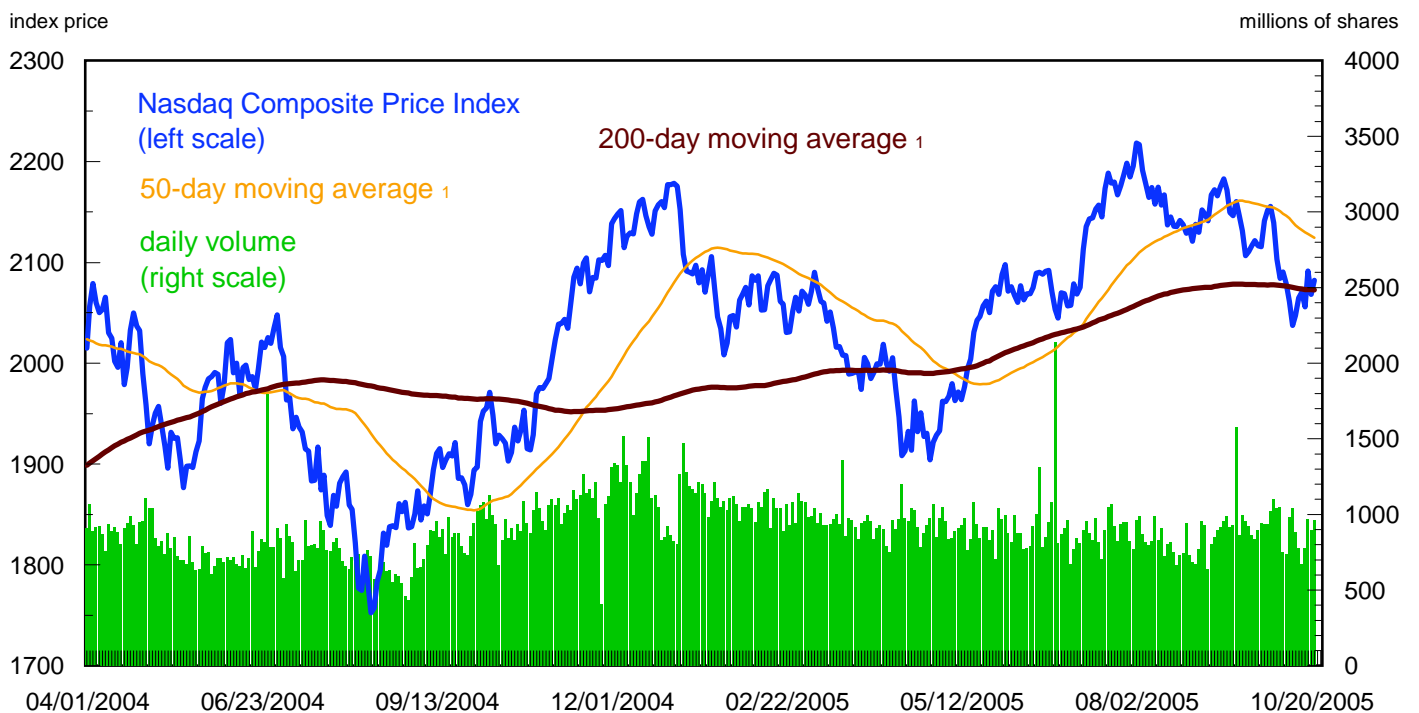
Please contact Maria Giduskova for questions and comments at [Maria.Giduskova@bos.frb.org](mailto:Maria.Giduskova@bos.frb.org), or by phone at (617) 973-3198.

Figure 1  
Daily Trends of Major U.S. Stock Exchanges

### New York Stock Exchange



### Nasdaq Stock Market

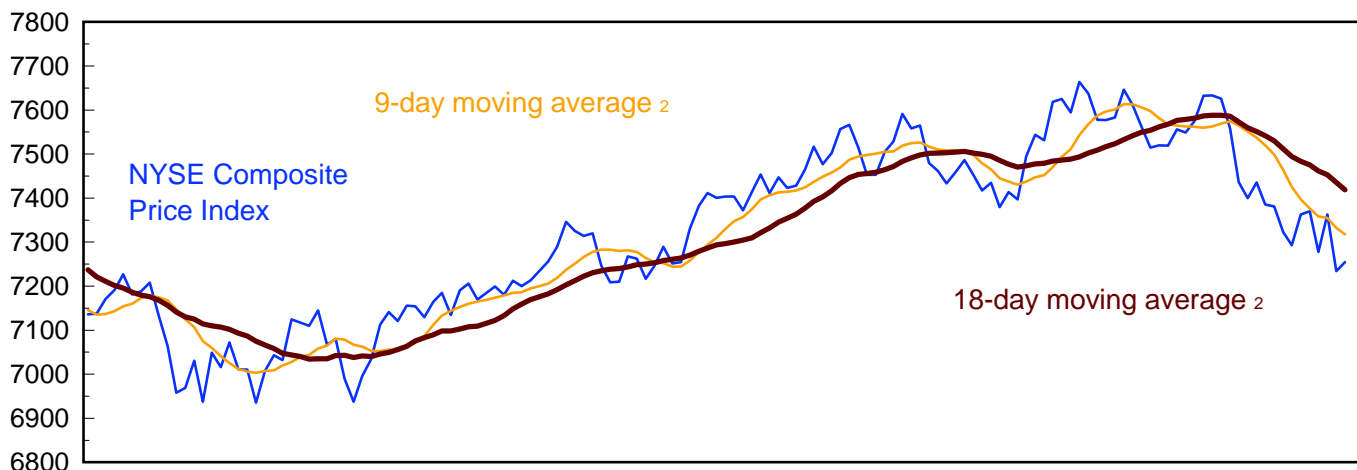


Source: Bloomberg, L.P.

Figure 2  
Moving Averages and Relative Strength

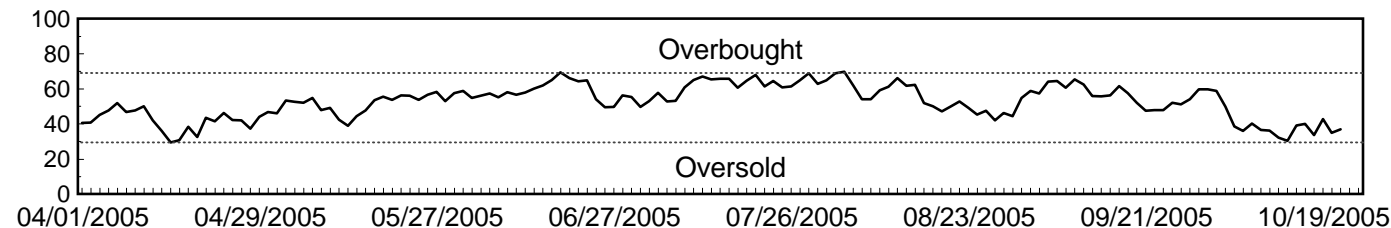
### New York Stock Exchange

index price



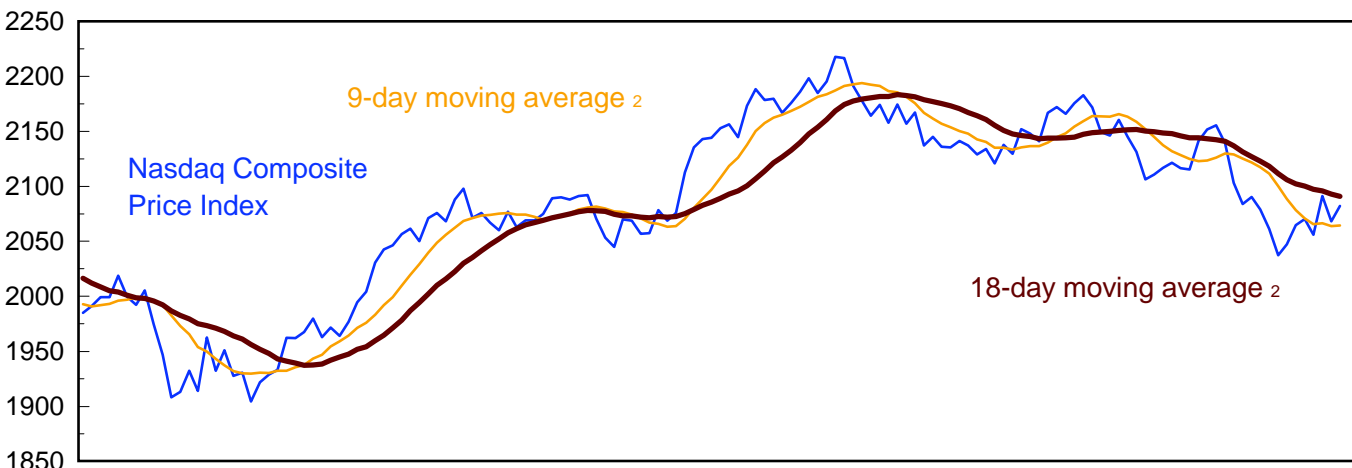
### Relative Strength Index <sup>3</sup>

percent



### Nasdaq Stock Market

index price



### Relative Strength Index <sup>3</sup>

percent

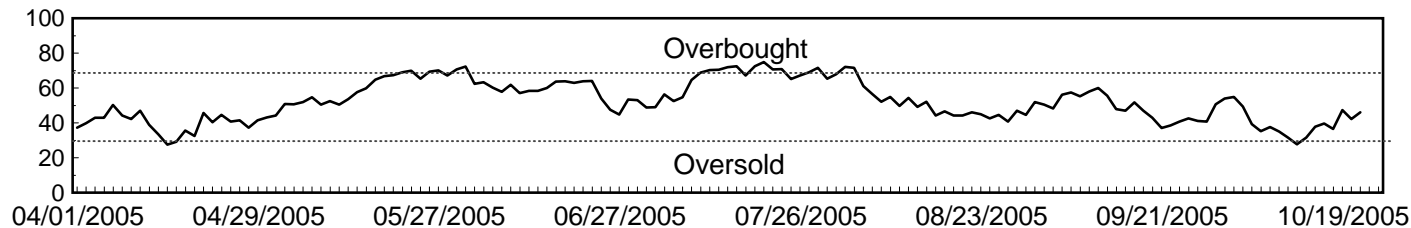
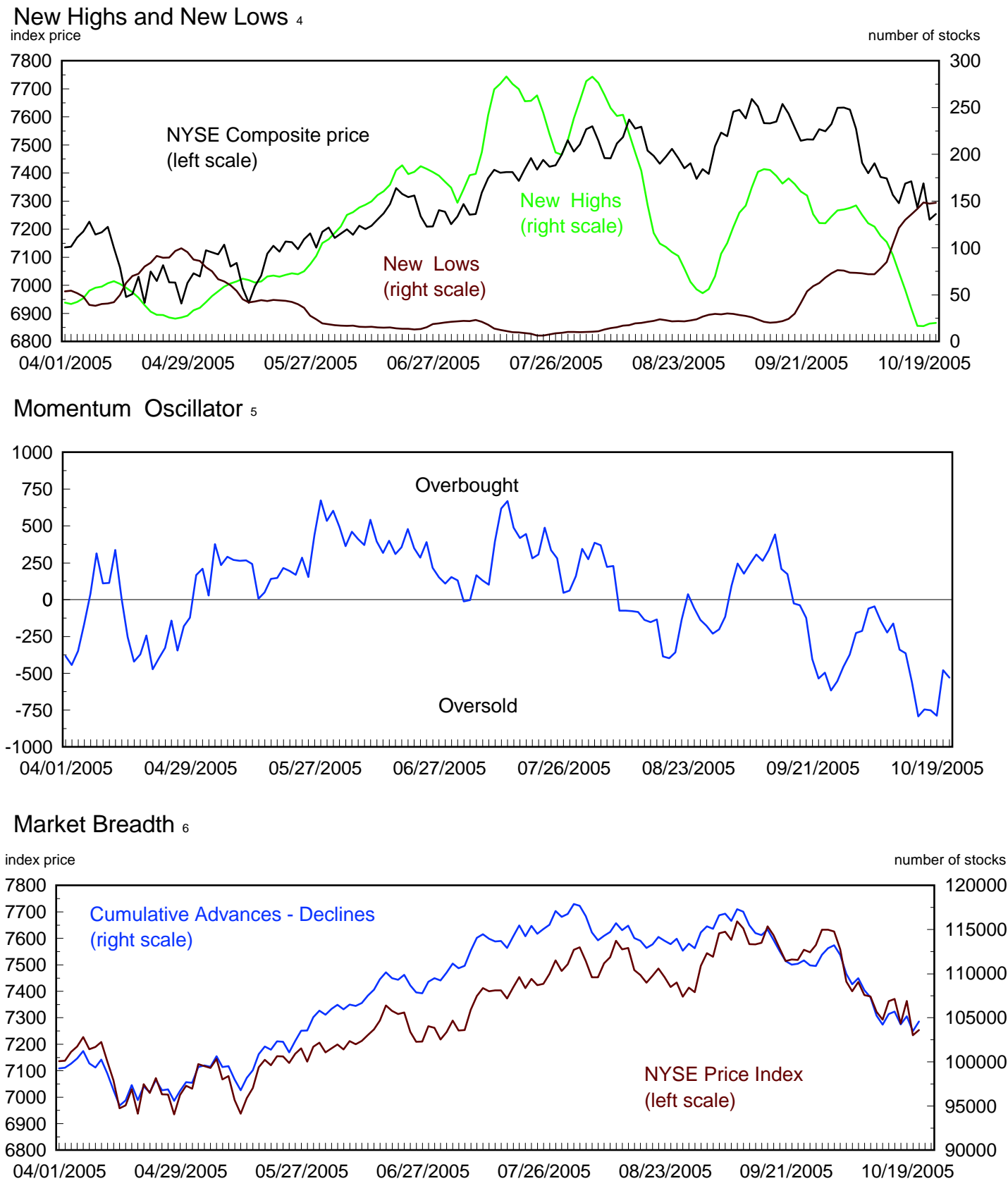


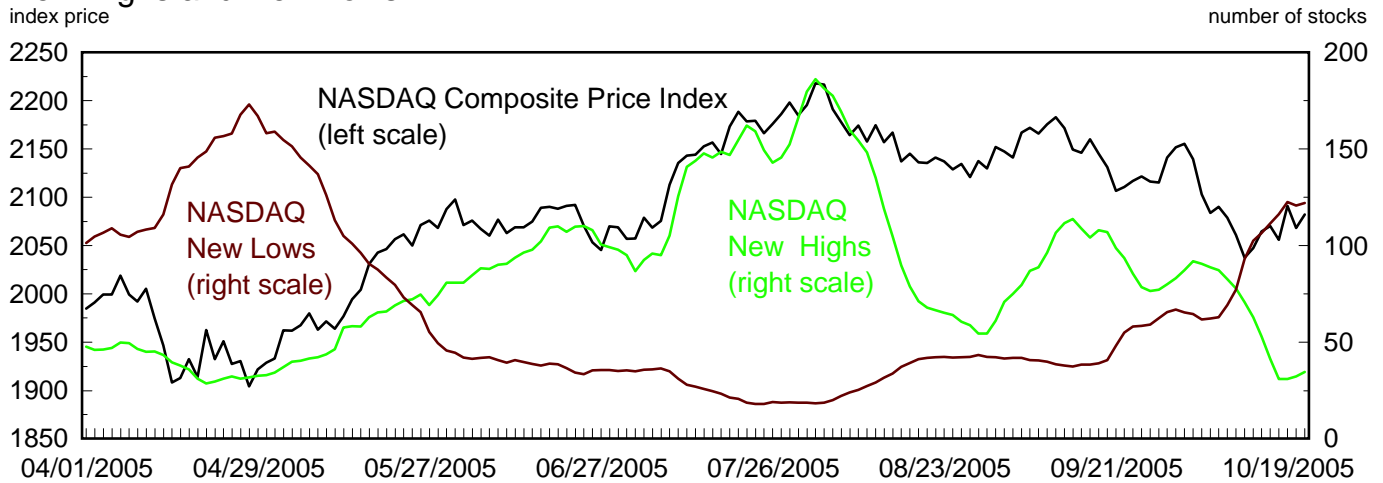
Figure 3  
Index Breadth and Momentum Indicators -  
New York Stock Exchange



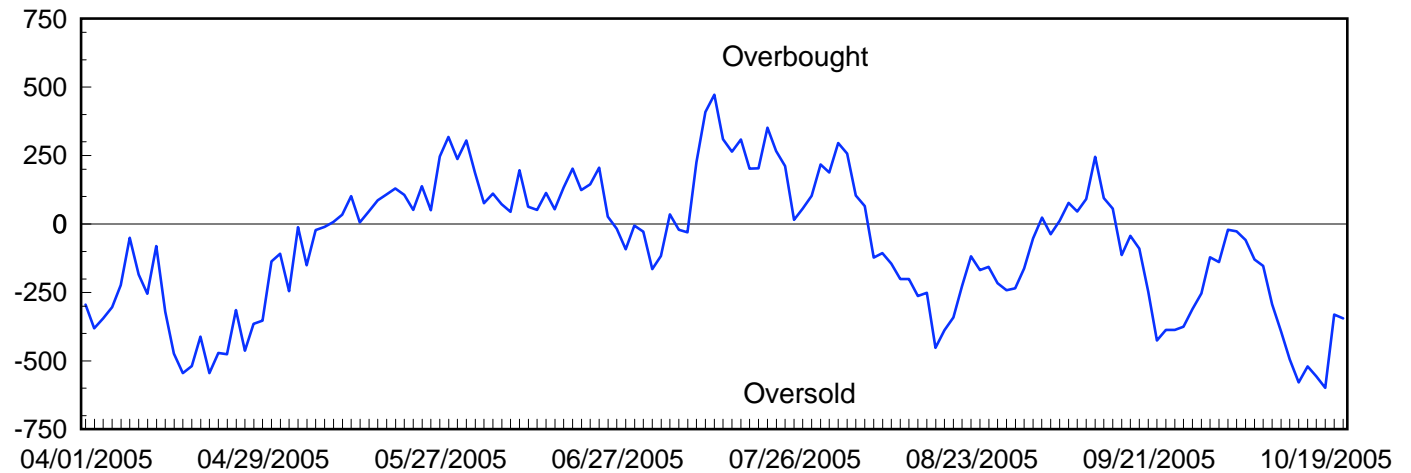
Source: Bloomberg, L.P.

Figure 4  
Index Breadth and Momentum Indicators -  
Nasdaq Stock Market

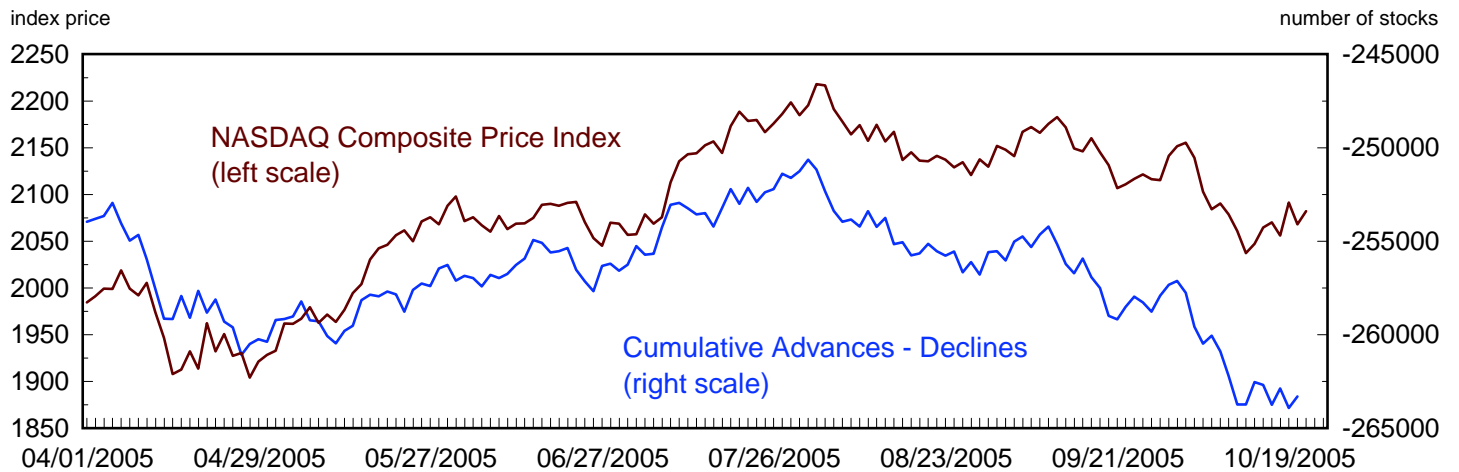
#### New Highs and New Lows <sup>4</sup>



#### Momentum Oscillator <sup>5</sup>



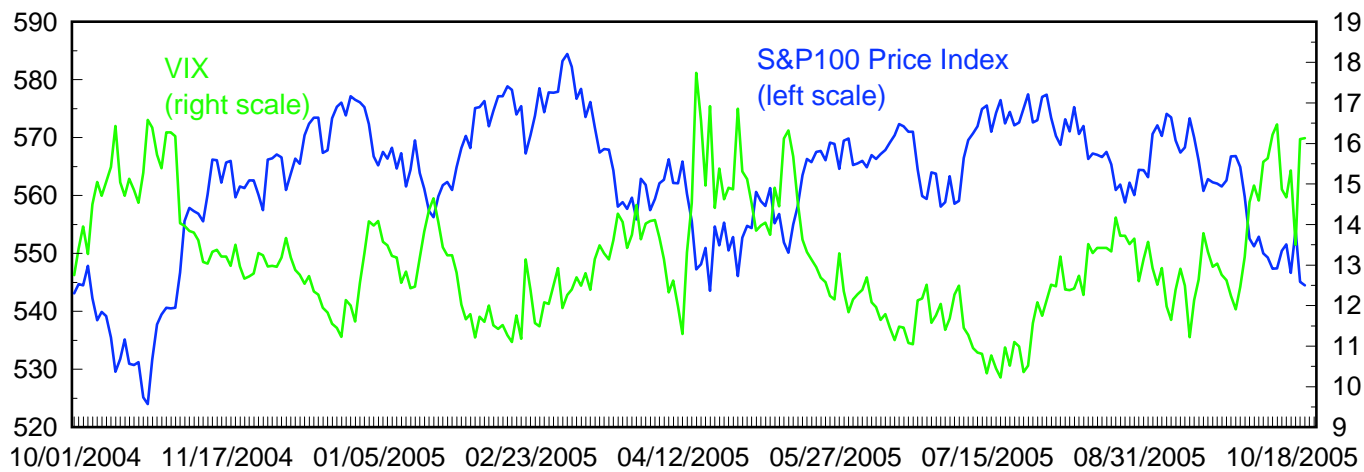
#### Market Breadth <sup>6</sup>



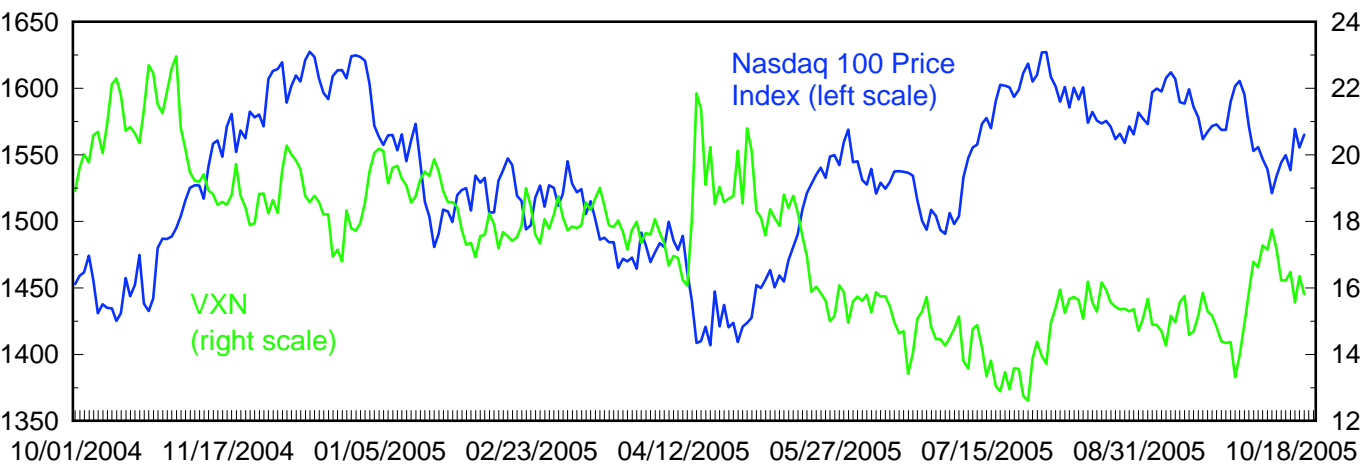
Source: Bloomberg, L.P.

Figure 5  
Volatility <sub>7</sub>

S&P100 and CBOE's OEX Volatility Index <sub>8</sub>  
index price



Nasdaq 100 and CBOE's NDX Volatility Index <sub>9</sub>  
index price



S&P500 Index Return and Implied Volatility  
percent

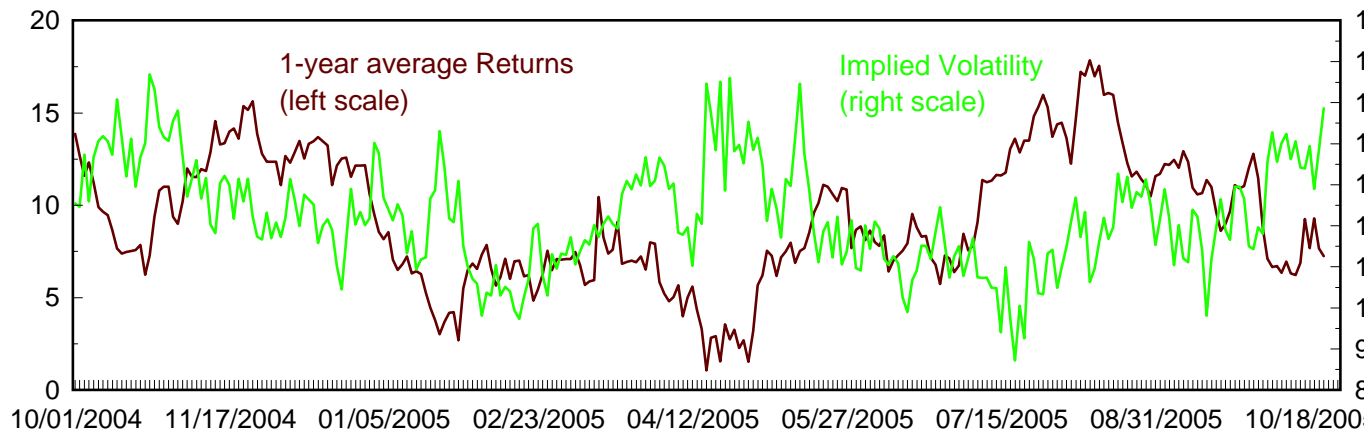
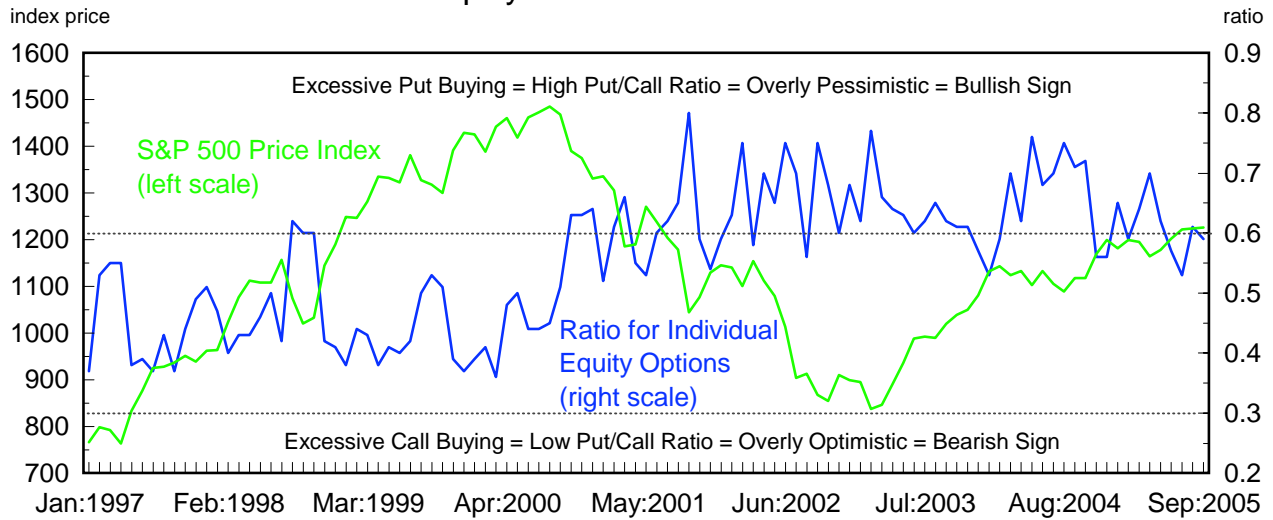


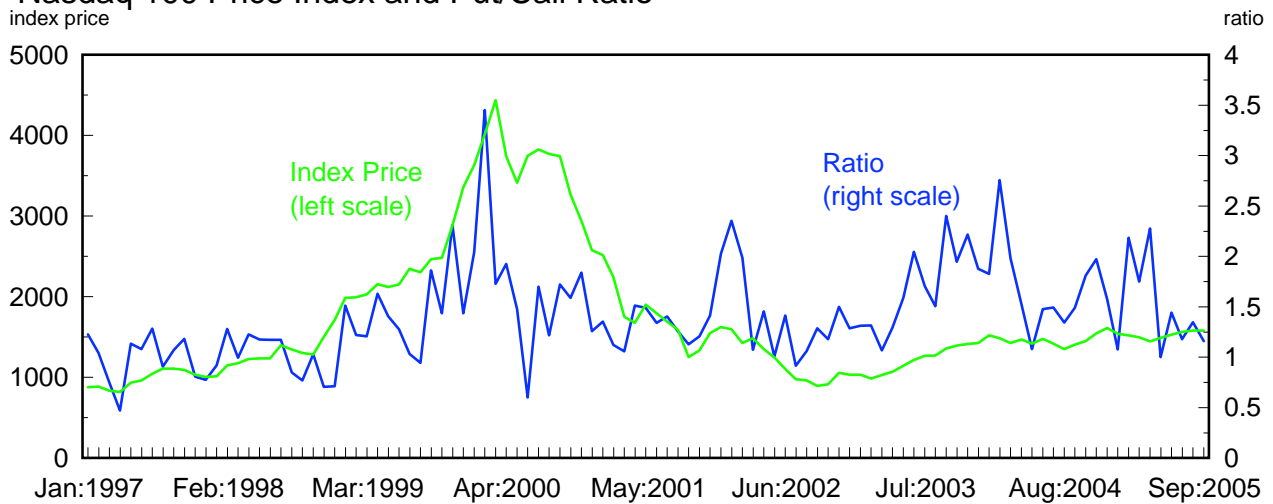


Figure 6  
Put / Call Ratio

### CBOE Index and Individual Equity Put/Call Ratios <sup>10</sup>



### Nasdaq 100 Price Index and Put/Call Ratio



### S&P 100 Price Index and Put/Call Ratios

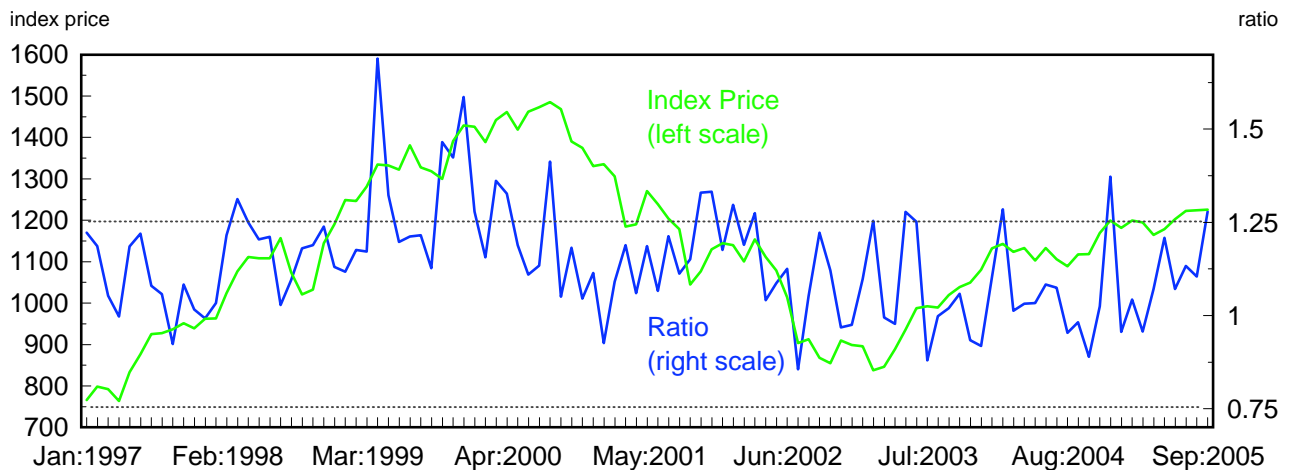


Figure 7  
S&P 500 Economic Sectors - Index Returns

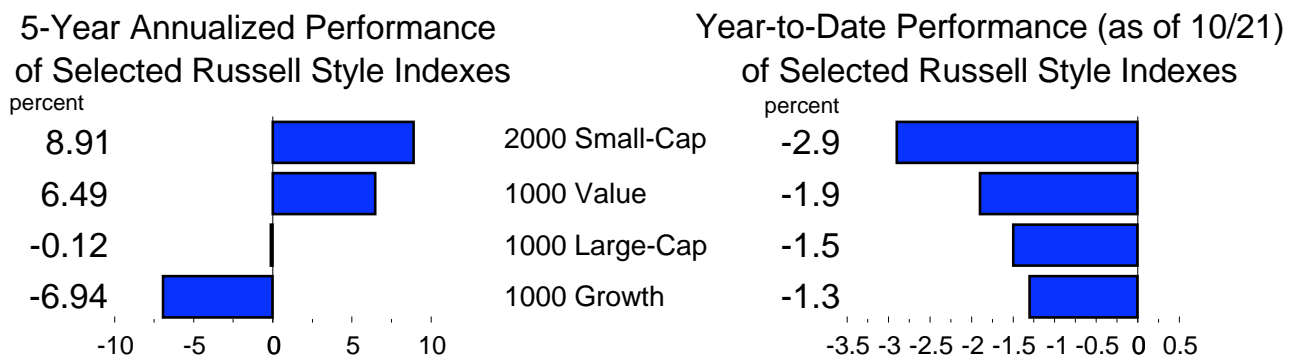
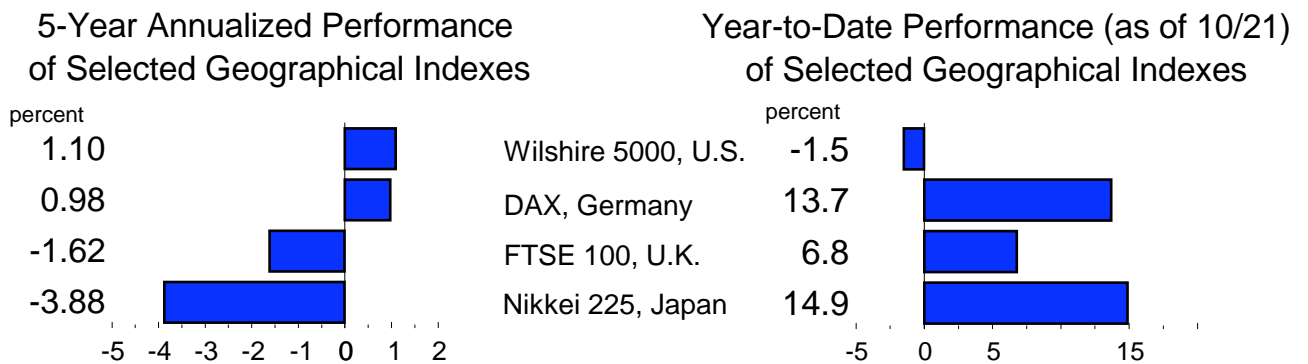
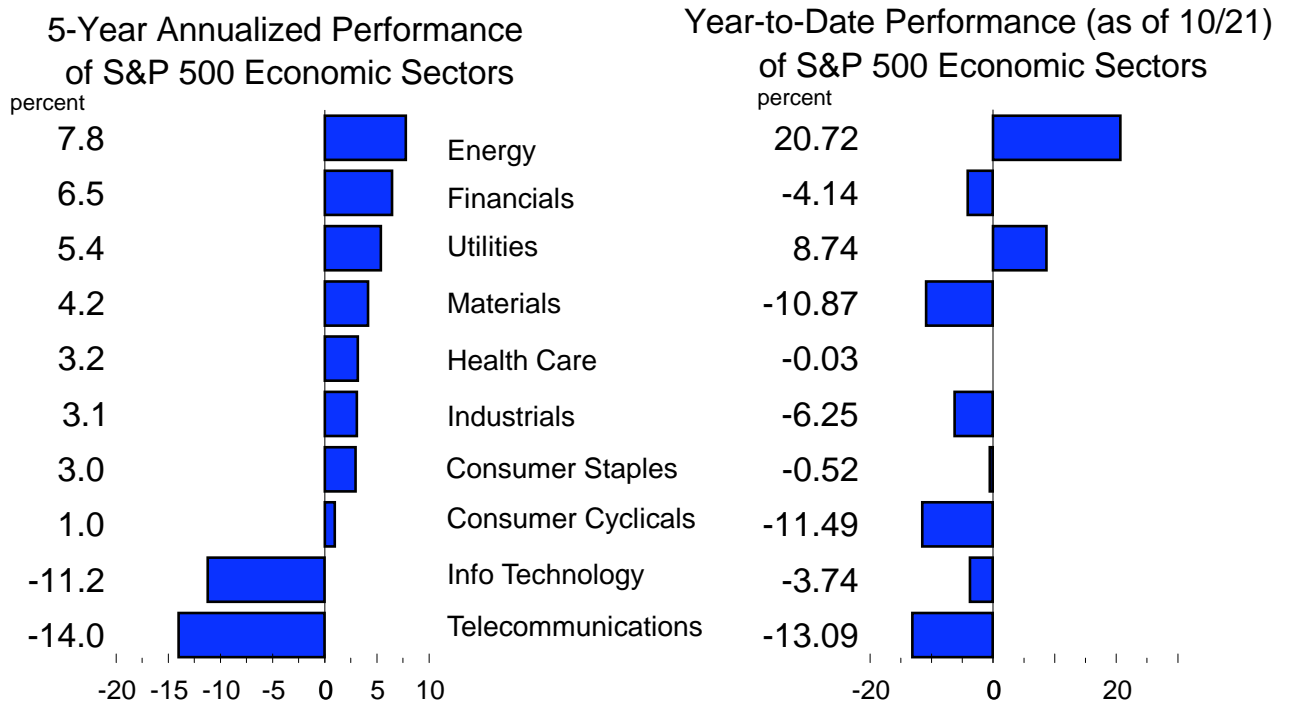
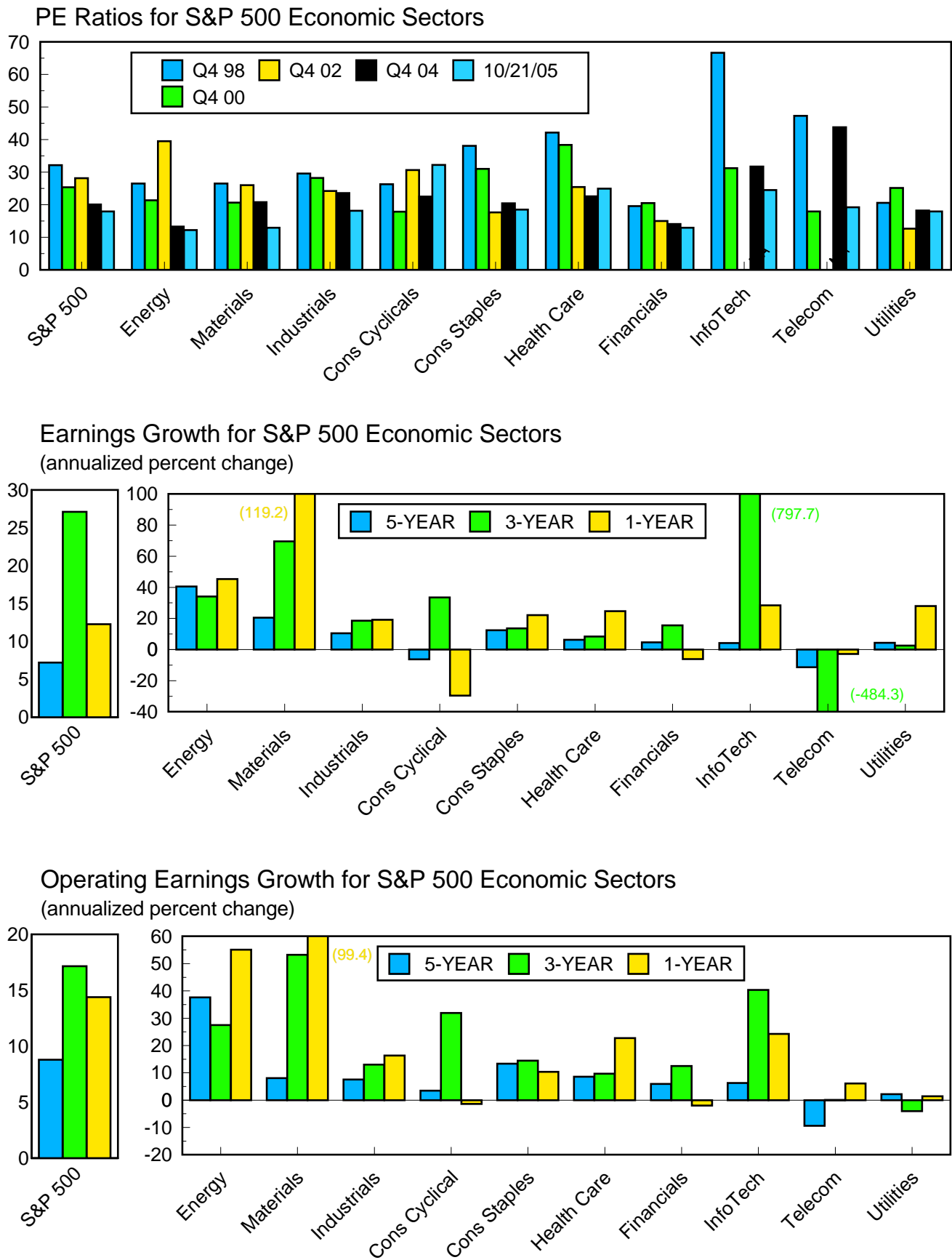


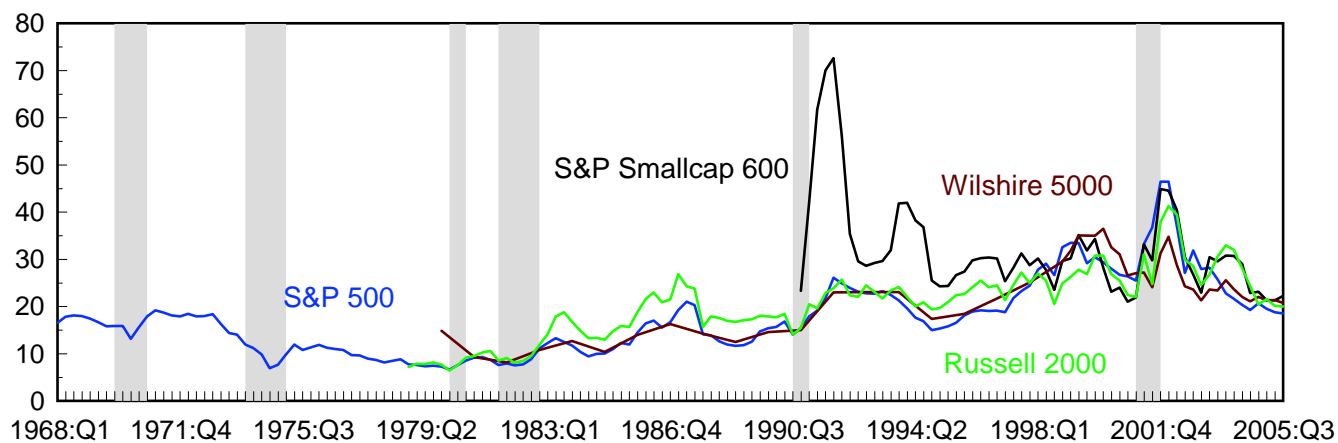
Figure 8  
 S&P 500 Economic Sectors - Earnings Growth



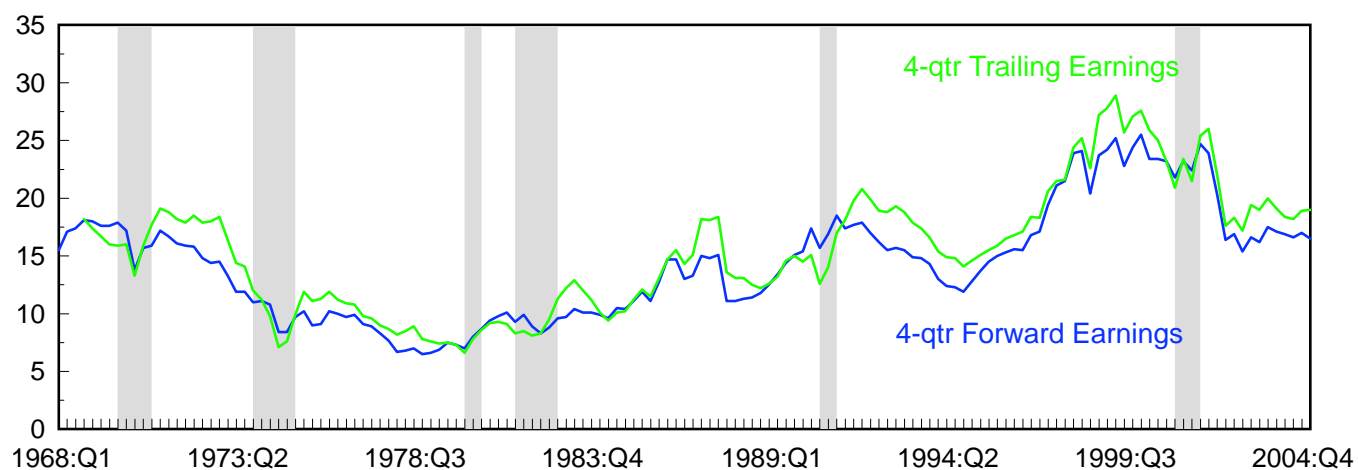
Source: Standard & Poor's Compustat, Bloomberg, L.P.

Figure 9  
PE Ratios and the Growth of Earnings

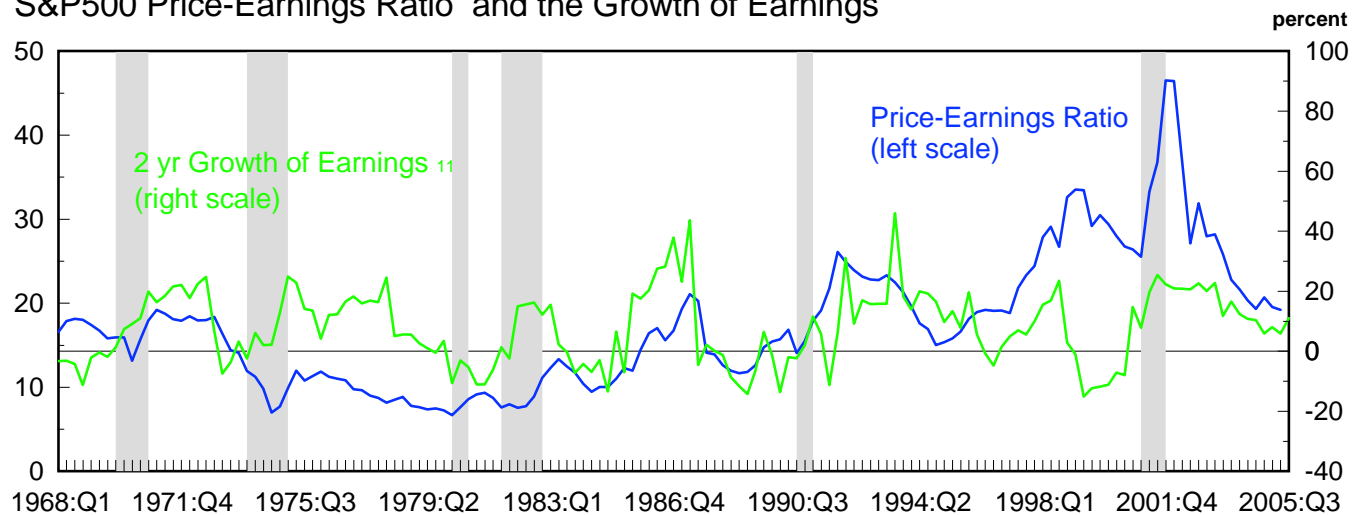
### Price-Earnings Ratios



### S&P500 Price-Operating Earnings Ratio



### S&P500 Price-Earnings Ratio and the Growth of Earnings



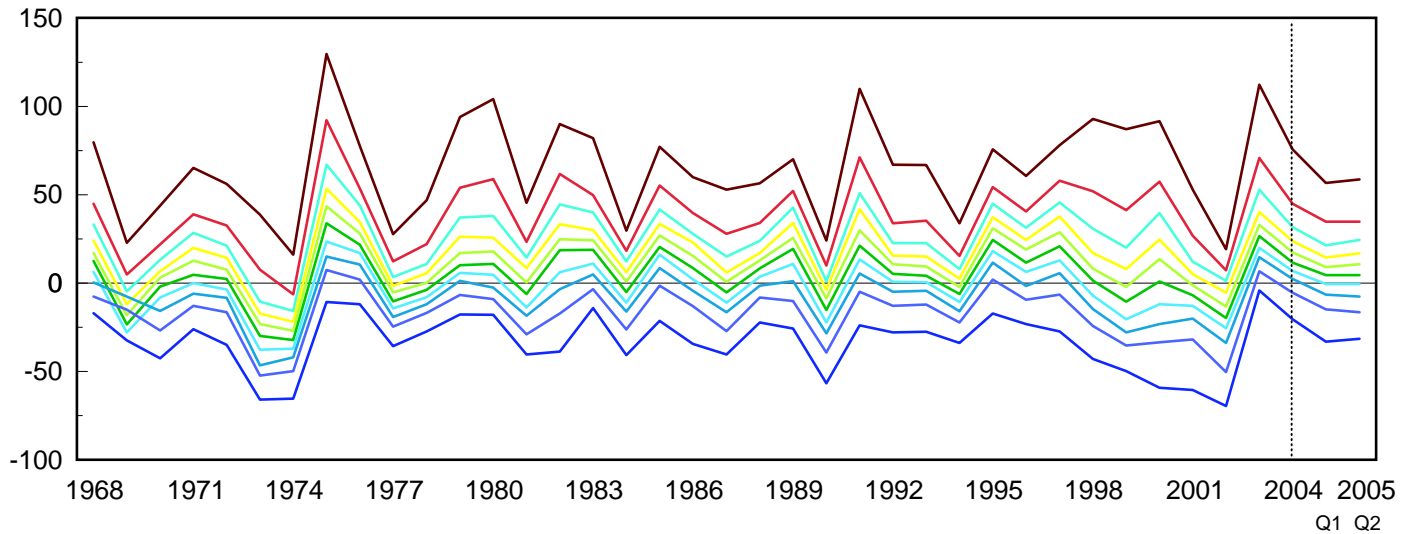
Source: Thomson Financial/First Call, Global Exchange (formerly DRI), Bloomberg L.P., Frank Russell Company, Haver Analytics

Figure 10

## Breadth of the S&P 500

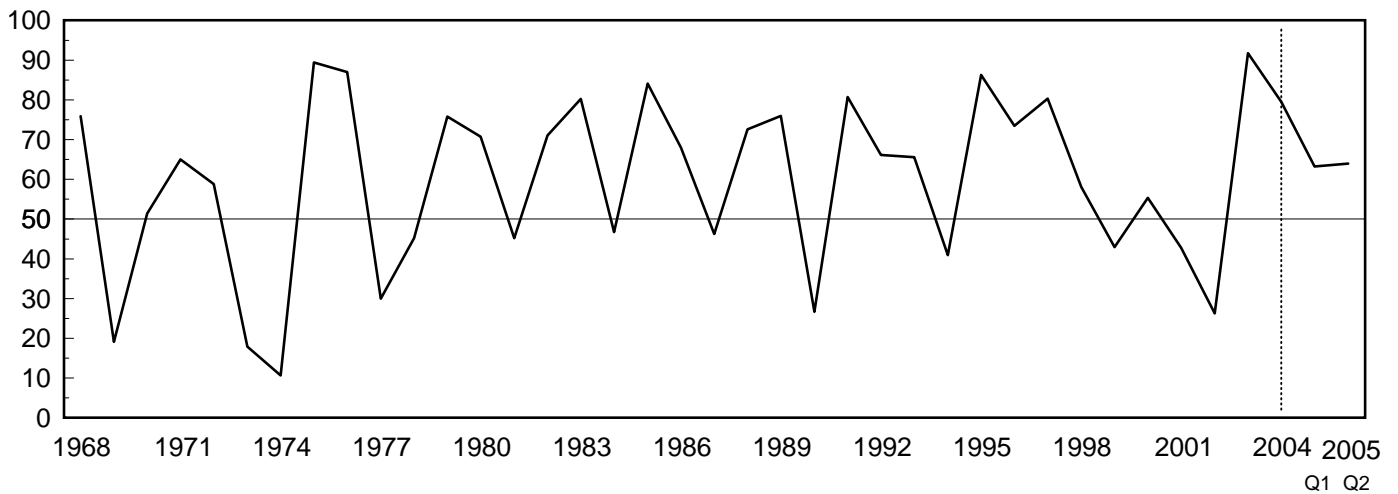
### One-Year Price Changes for Companies

(median percentage change for each decile, ranked by performance)



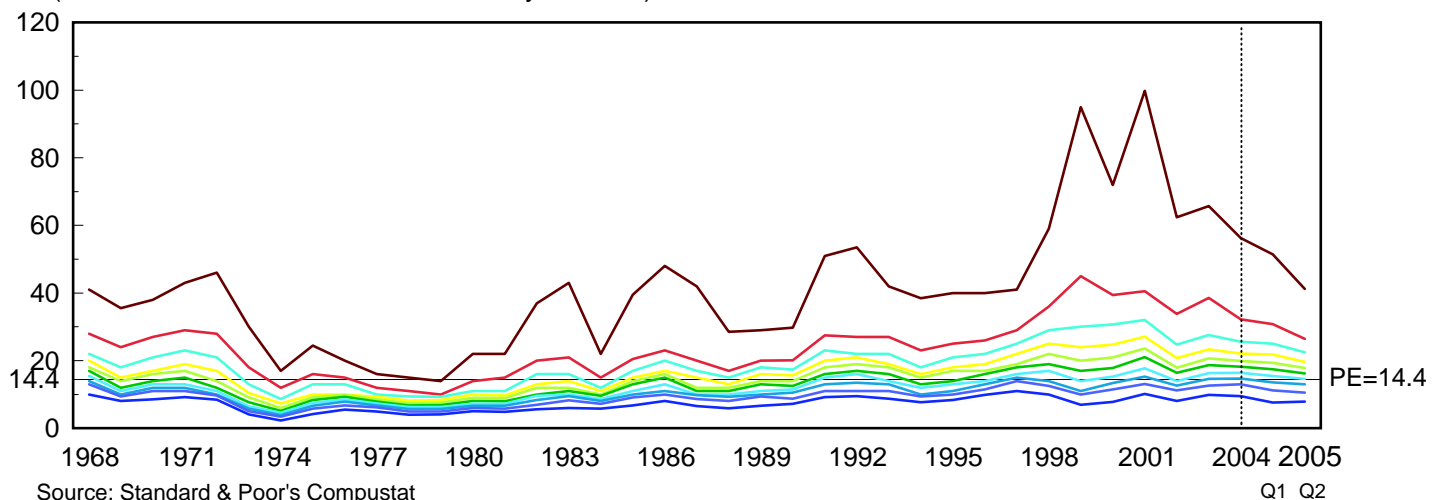
### Proportion of the S&P 500 Stocks Whose Price Increased Over One Year

percent



### Price-Operating Earnings Ratios for Companies

(median ratio for each decile, ranked by PE ratio)

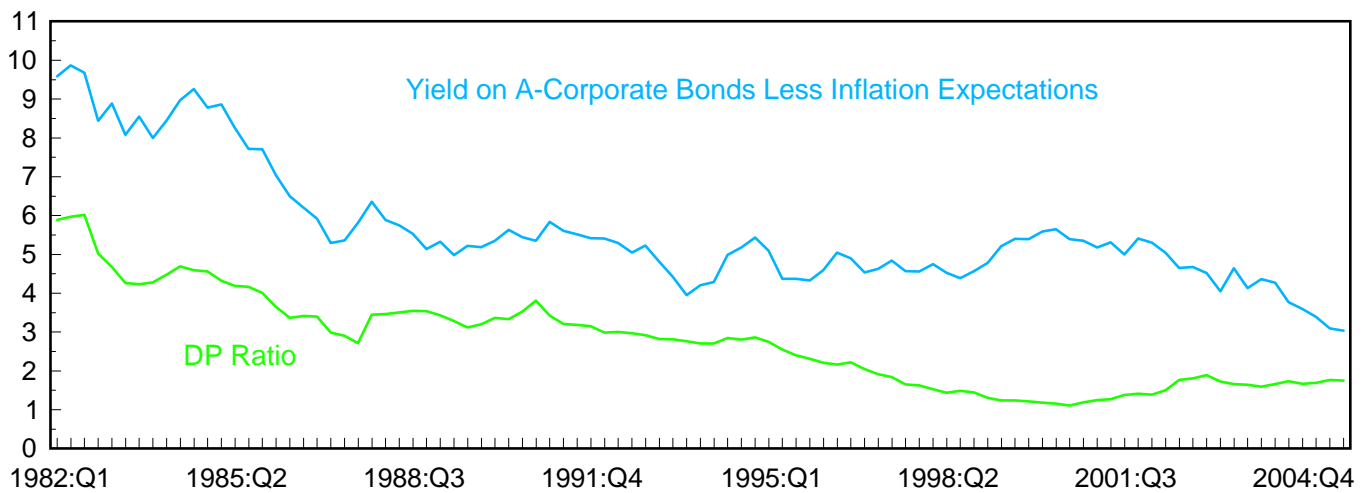


Source: Standard & Poor's Compustat

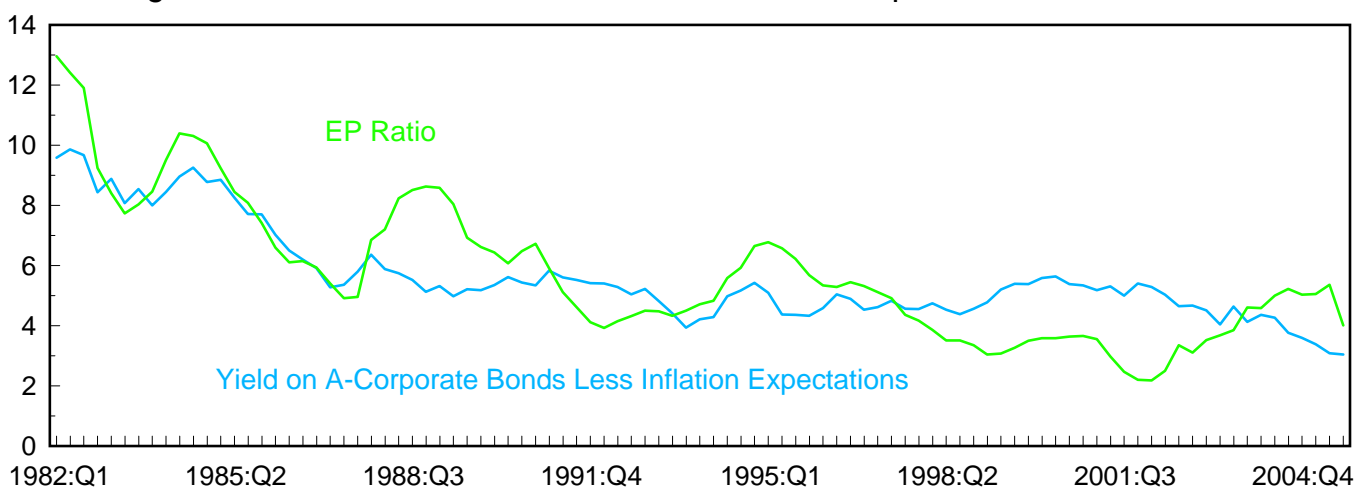
Figure 11

## Comparative Returns

Dividend-Price Ratio <sup>12</sup> for the S&P 500 and the Real Corporate Bond Rate <sup>13</sup>



Earnings-Price Ratio <sup>12</sup> for the S&P 500 and the Real Corporate Bond Rate



Growth of Real Earnings for S&P 500

(average rate of growth for 2 years forward)

percent

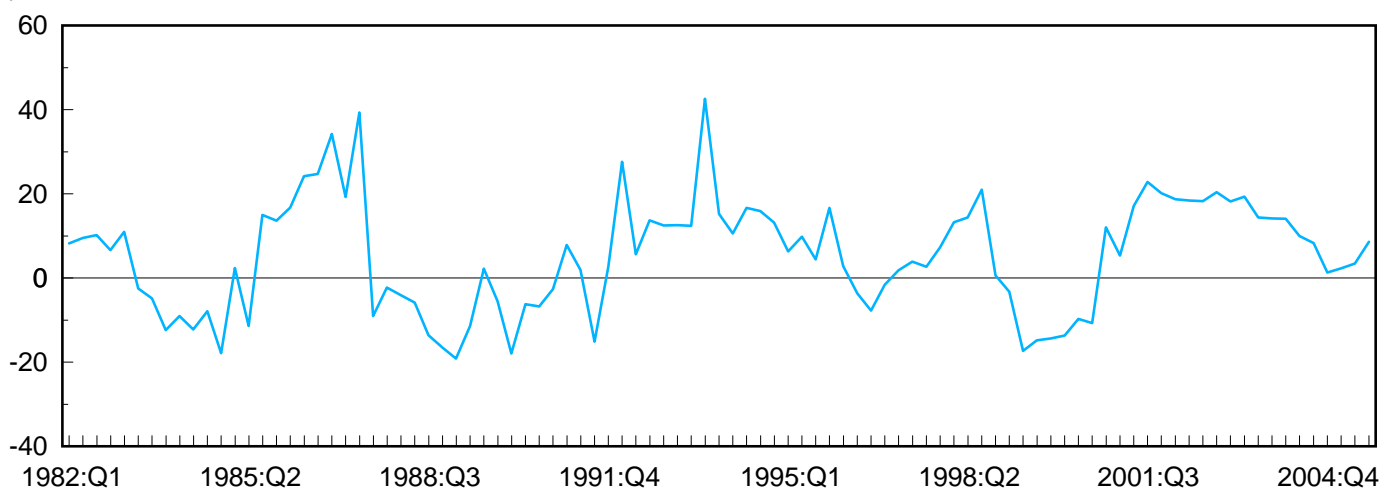


Figure 12  
Dividend Yields

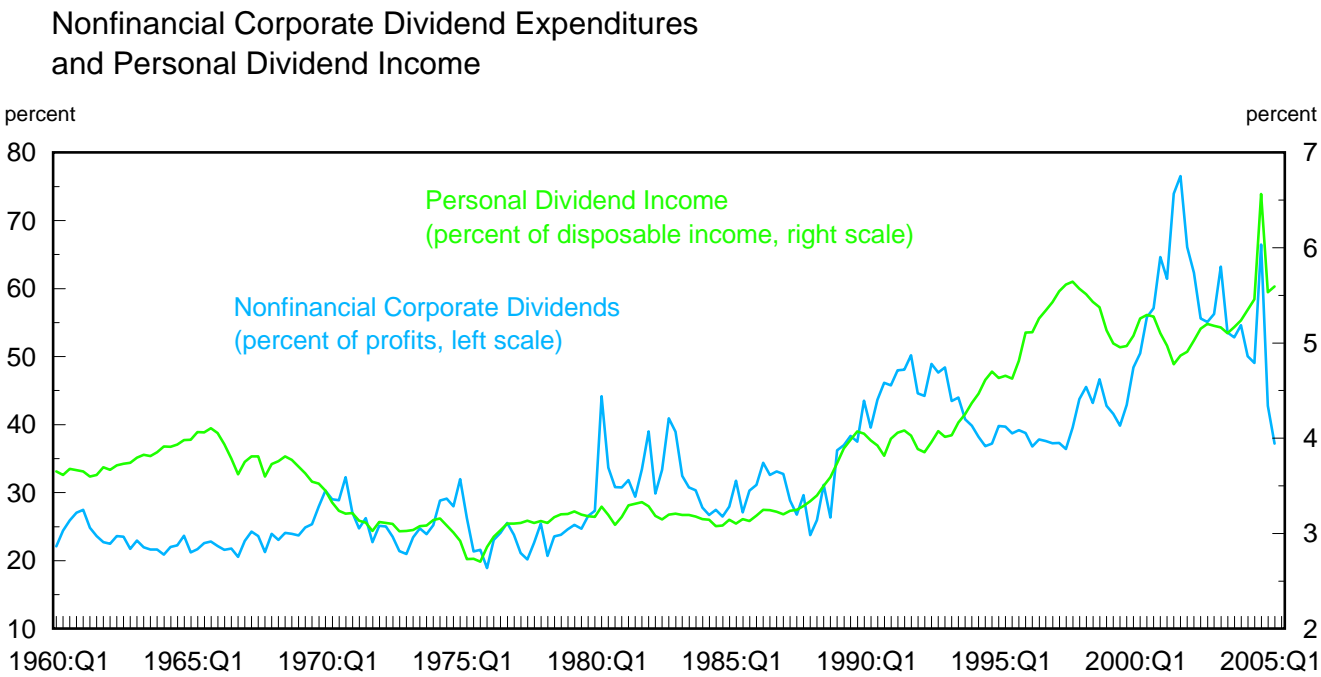
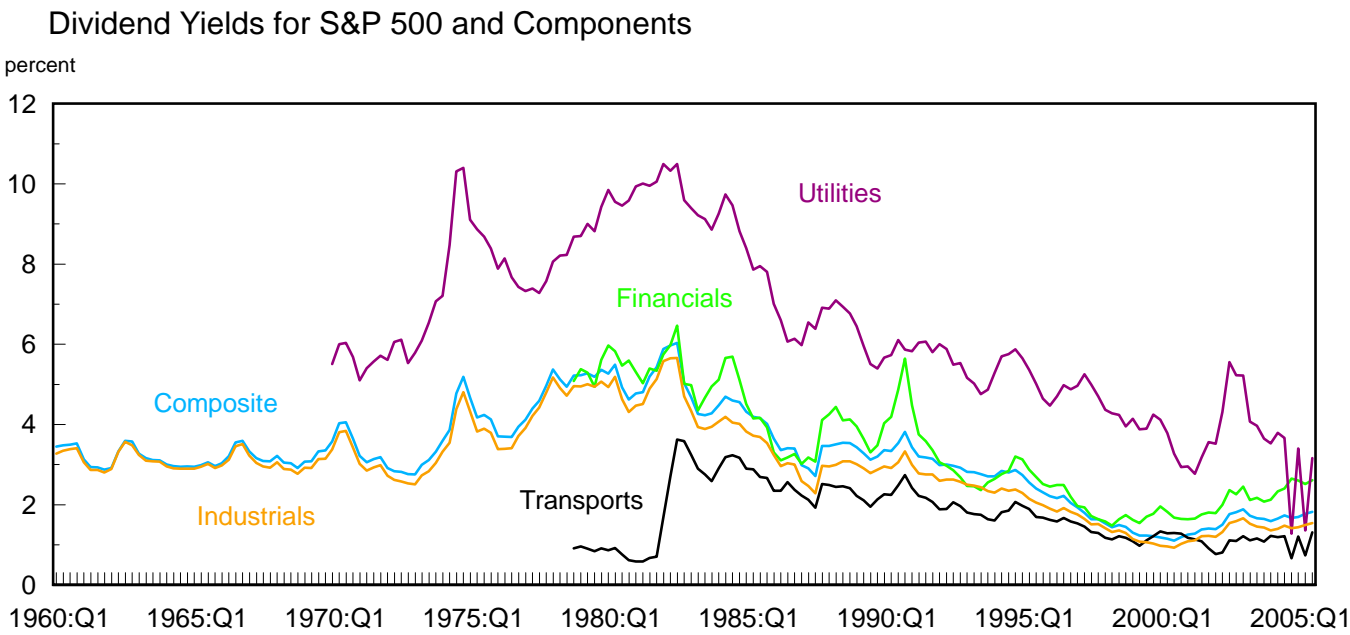
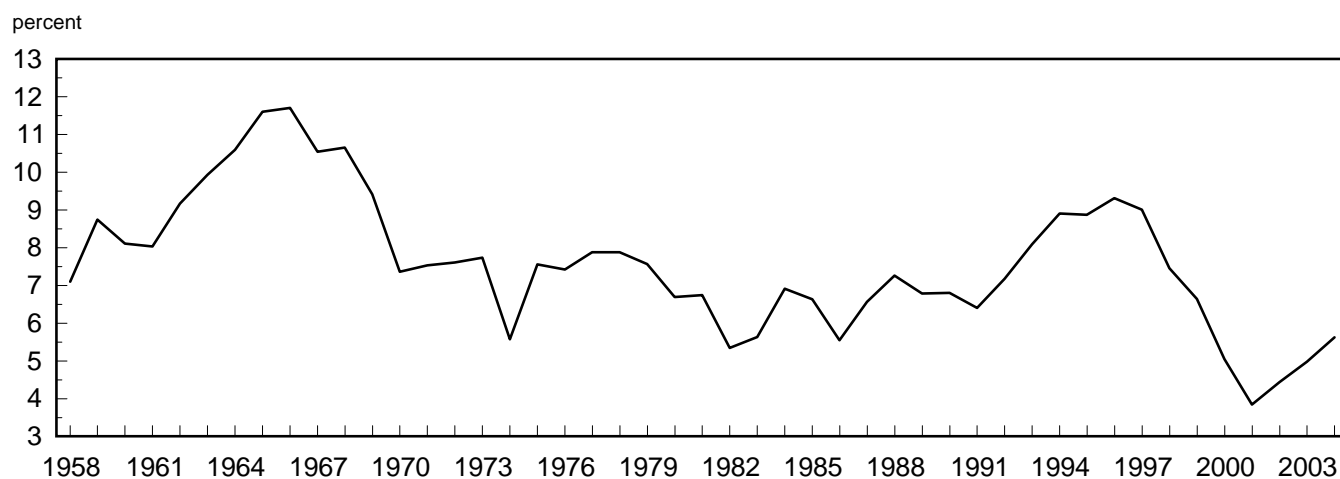
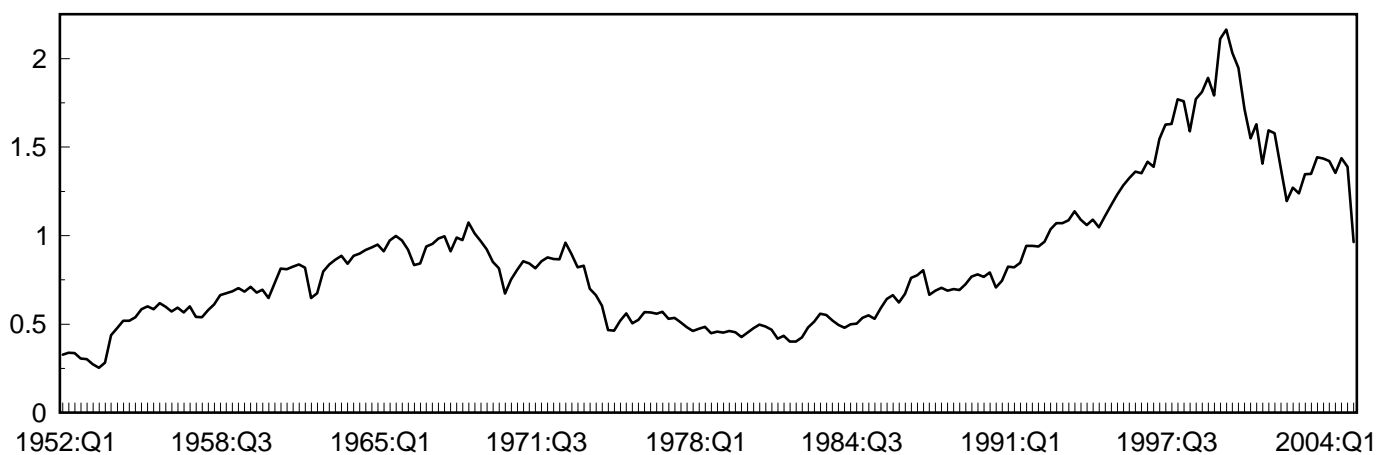


Figure 13  
Economic Measures of Equity Valuation

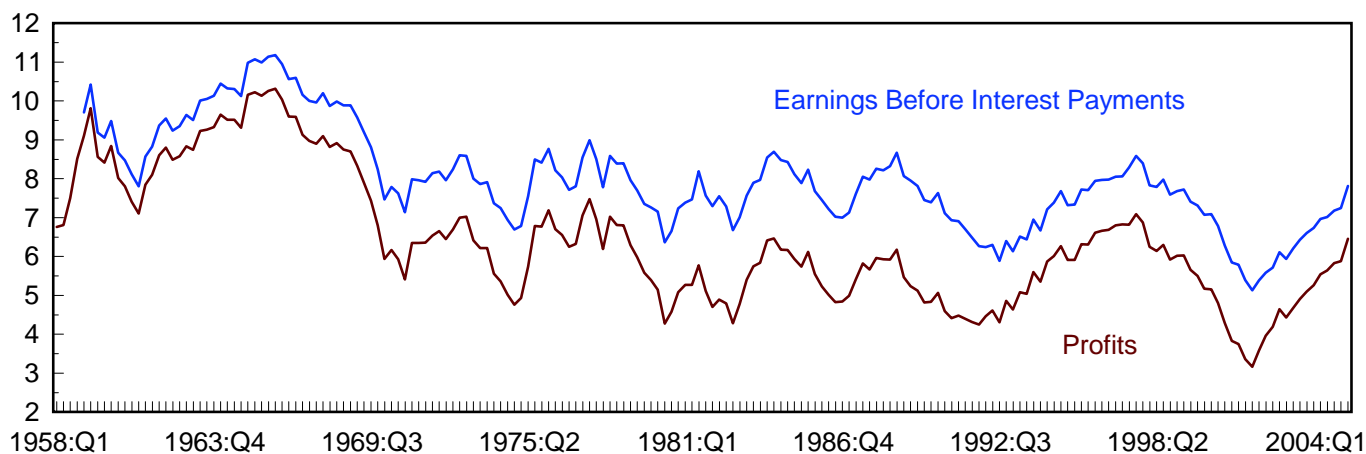
Real Rate of Return on Nonfinancial Corporate Equity  
(from National Income and Flow of Funds Accounts)



Tobin's  $q$  <sup>14</sup>



Profits of Nonfinancial Corporations  
(percent of GDP)

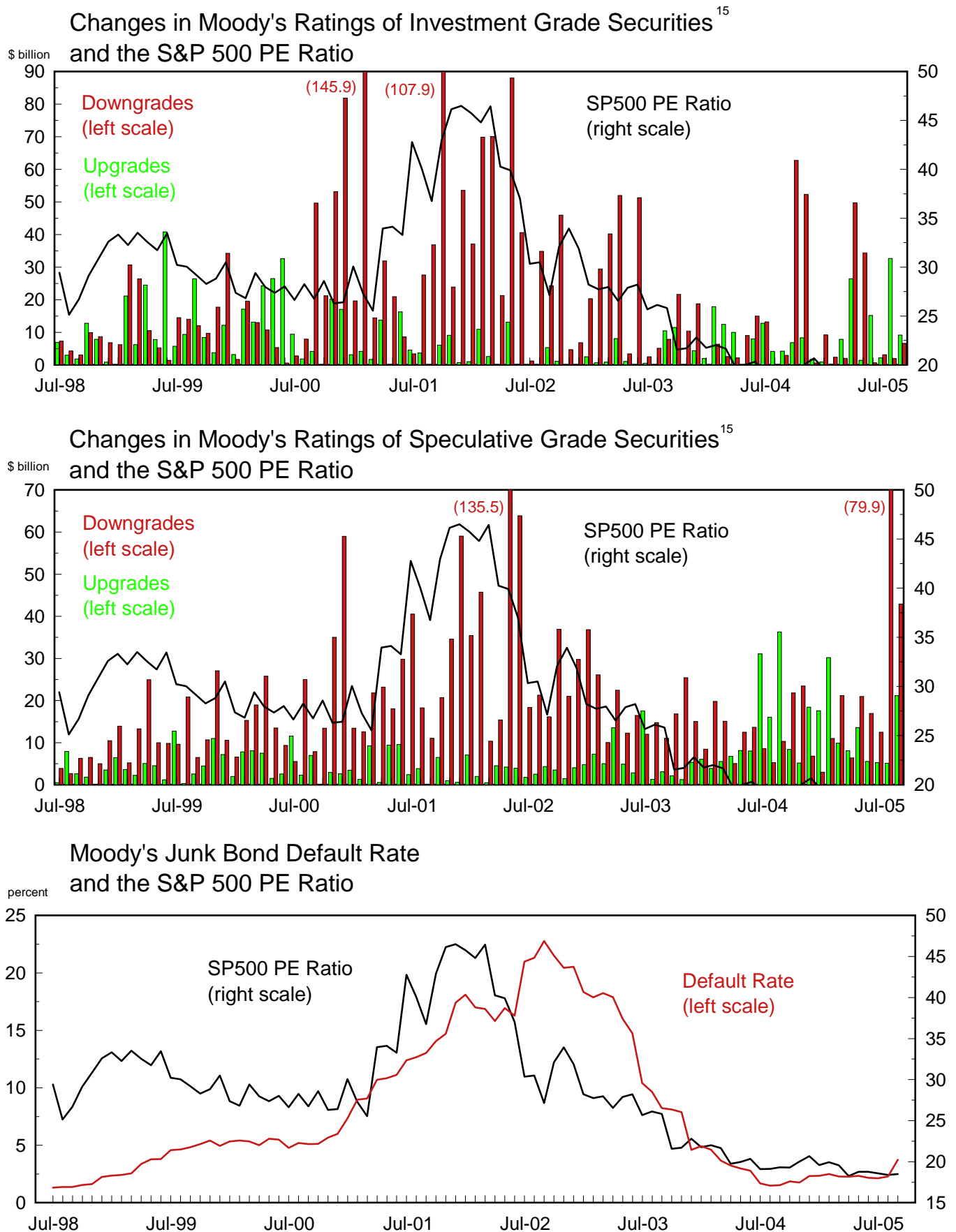


Source: Haver Analytics, NYSE Fact Book, Flow of Funds Accounts



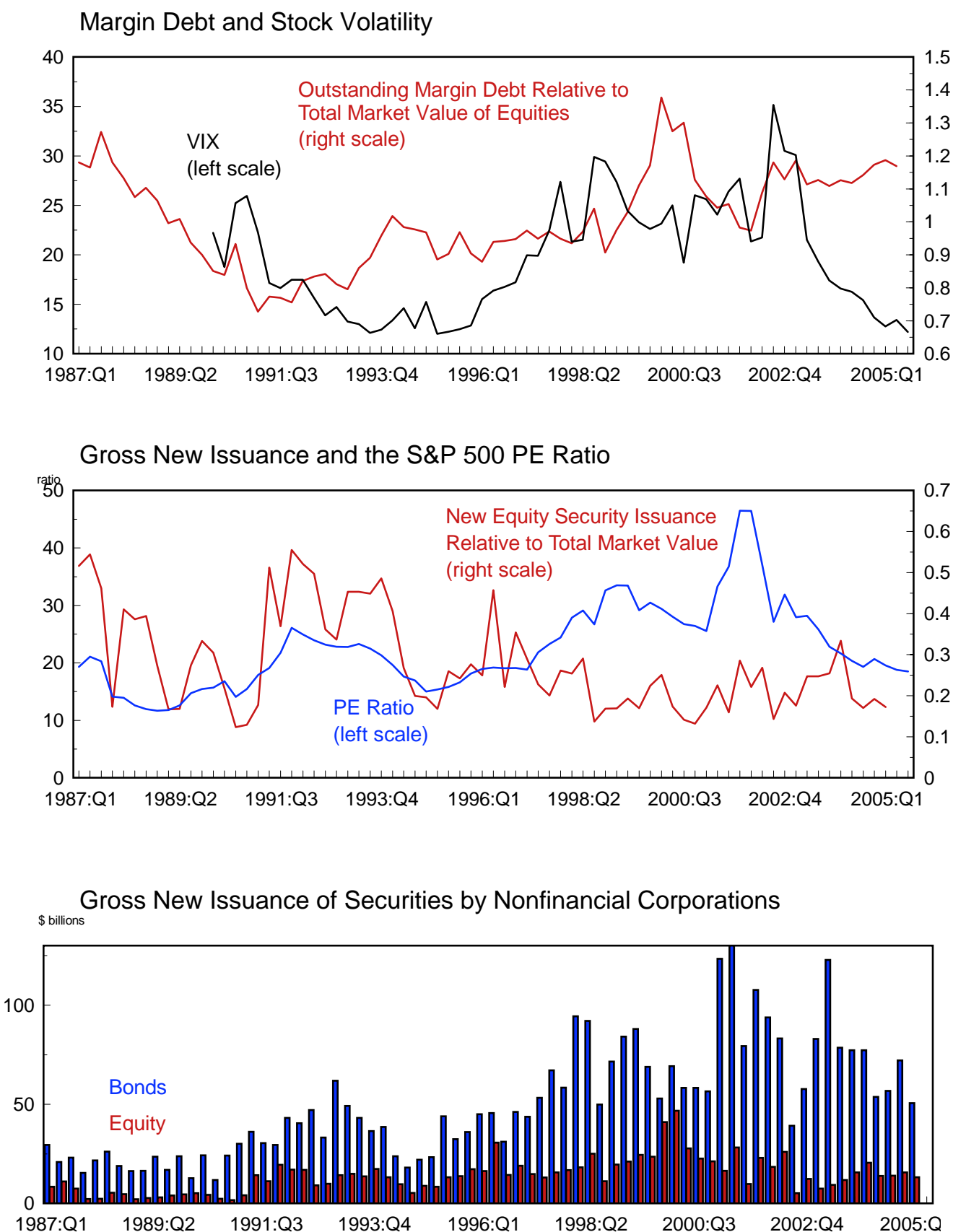
Figure 14

## Ratings and Default Rates



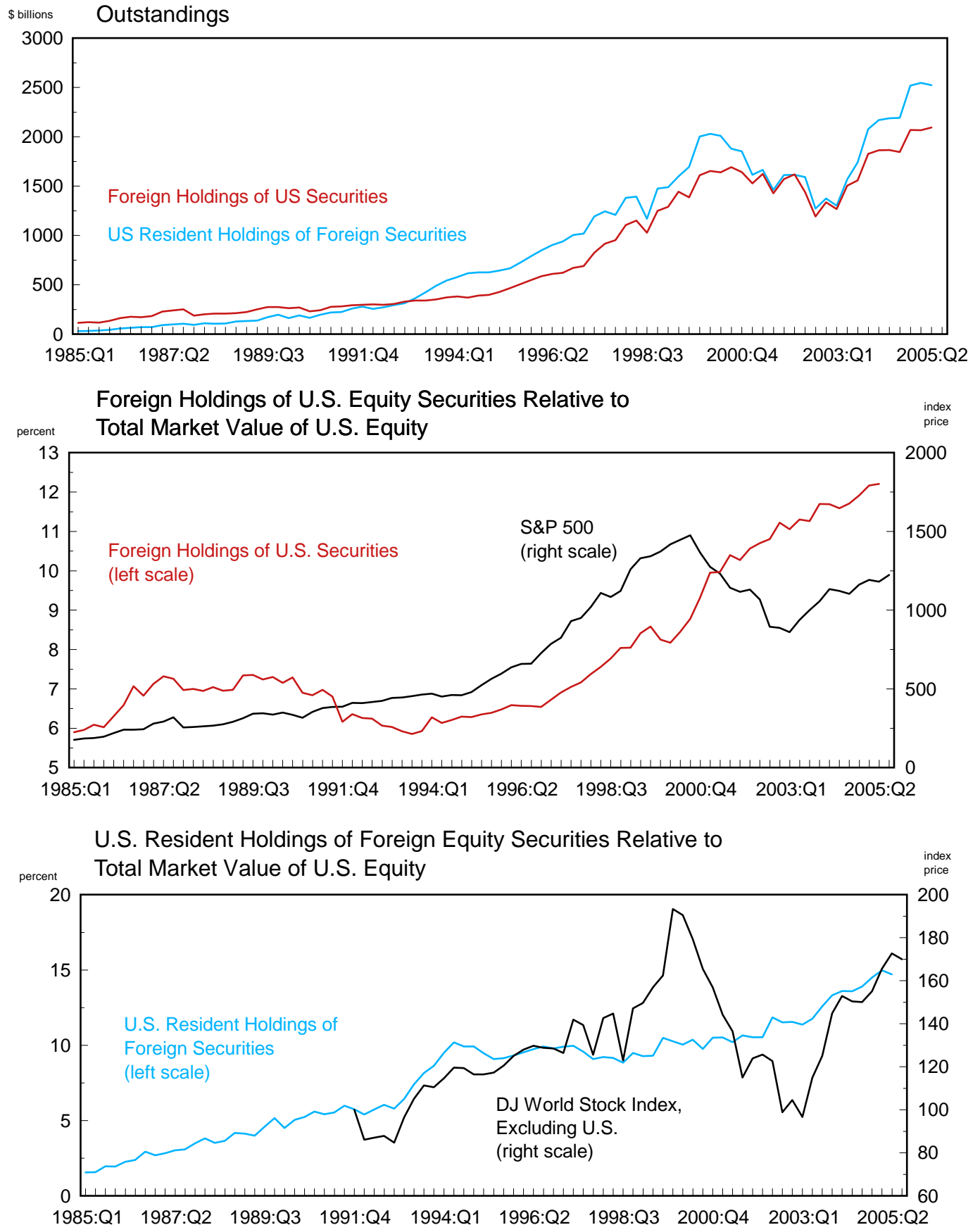
Source: Credqual database, Board of Governors of the Federal Reserve System

Figure 15  
Margin Debt and Expected Returns



Sources: Haver Analytics, FAME

Figure 16  
Foreign and Domestic Holdings



Source: Haver Analytics, FAME, Flow of Funds Accounts of the United States

## Endnotes

1. 50-Day, 200-Day Moving Average: Moving averages represent the average price investors paid for securities over a historical period, and present a smoothed picture of the price trends, eliminating the volatile daily movement. Because these lines offer a historical consensus entry point, chartists look to moving average trend lines of index prices to define levels of support or resistance in the market. When a chart trend is predominantly sideways (Figure 1, top chart), moving averages and the underlying series frequently cross, but during a time of prolonged increase or decrease (bottom chart) the daily prices of a security typically are above or below the trailing average. Moving above or below the 50-day moving average is sometimes associated with rallies or corrections. Similarly, prolonged movements, such as bull and bear markets can be represented by securities remaining above or below their 200-day moving average for prolonged periods of time.
2. 9-Day, 18-Day Moving Averages: The 9-day and 18-day moving averages are often used together to provide buy and sell signals. Buy signals are indicated by the 9-day average crossing above the 18-day when both are in an uptrend. The reverse, the 9-day crossing below the 18-day while both moving averages are declining is a sign to sell. However, this simple can often be misleading because of its dependence on trending markets and inability to capture quick market turns.
3. Relative Strength Index: This (RSI) momentum oscillator measures the velocity of directional price movements. When prices move rapidly upward they may indicate an overbought condition, generally assumed to occur above 70 percent. Oversold conditions arise when prices drop quickly producing RSI readings below 30 percent.
4. New Highs, New Lows: A straightforward breadth indicator, this is the 10-day moving average of the number of stocks on a given index or exchange making new 52-week highs or lows each day. This indicator also demonstrates divergence. If an index makes a new low, but the number of stocks in the index making new lows declines, there is positive divergence, and in this case a lack of downside conviction. Conversely, In rising markets if an index makes a new high but the number of individual stocks in that index making new highs does not increase this suggests a false rally.
5. Overbought / Oversold Oscillator: This momentum indicator is calculated by taking the 10-day moving average of the difference between the number of advancing and declining issues for a given index. The goal of the indicator is to show whether an index is gaining or losing momentum, so the size of the moves are more important than the level of the current reading. This is first affected by how the oscillator changes each day, by dropping a value ten days ago, and adding one today. If the advance decline line read minus 300 ten days ago, and minus 100 today, even though the market is down again, the oscillator will rise by 200 because of the net difference of the exchanged days' values. This suggests a

trough, however, if today's reading was minus 500 it would demonstrate a gain in downside momentum.

The magnitude in moves is useful when compared with divergence to the index price. If the Dow peaks at the same time the oscillator peaks in overbought territory, it suggests a top. If the index then makes a new high but the oscillator fails to make a higher high, divergence is negative and momentum is declining. If the index at this point declines and the oscillator moves into oversold territory it may again be time to buy. If the index rises but does not make new highs, but the oscillator continues to rise above a previous overbought level, upside momentum exists to continue the rally.

6. Cumulative Advance / Decline Line: Referred to as market breadth, the indicator is the cumulative total of advancing minus declining issues each day. When the line makes new highs a rally is considered widespread, but when lagging a rally is seen as narrow.
7. Volatility: With regard to stock prices and stock index levels, volatility is a measure of changes in price expressed in percentage terms without regard to direction. This means that a rise from 200 to 202 in one index is equal in volatility terms to a rise from 100 to 101 in another index, because both changes are 1 percent. Also, a 1 percent price rise is equal in volatility terms to a 1 percent price decline. While volatility simply means movement, there are four ways to describe this movement:
  1. *Historic volatility* is a measure of actual price changes during a specific time period in the past. Mathematically, historic volatility is the annualized standard deviation of daily returns during a specific period. CBOE provides 30 day historical volatility data for obtainable stocks in the Trader's Tools section of this Web site.
  2. *Future volatility* means the annualized standard deviation of daily returns during some future period, typically between now and an option expiration. And it is future volatility that option pricing formulas need as an input in order to calculate the theoretical value of an option. Unfortunately, future volatility is only known when it has become historic volatility. Consequently, the volatility numbers used in option pricing formulas are only estimates of future volatility. This might be a shock to those who place their faith in theoretical values, because it raises a question about those values. Theoretical values are only estimates, and as with any estimate, they must be interpreted carefully.
  3. *Expected volatility* is a trader's forecast of volatility used in an option pricing formula to estimate the theoretical value of an option. Many option traders study market conditions and historical price action to forecast volatility. Since forecasts vary, there is no specific number that everyone can agree on for expected volatility.
  4. *Implied volatility* is the volatility percentage that explains the current market price of an option; it is the common denominator of option prices. Just as p/e ratios allow comparisons of stock prices over a range of variables such as total

earnings and number of shares outstanding, implied volatility enables comparison of options on different underlying instruments and comparison of the same option at different times. Theoretical value of an option is a statistical concept, and traders should focus on relative value, not absolute value. The terms "overvalued" and "undervalued" describe a relationship between implied volatility and expected volatility. Two traders could differ in their opinion of the relative value of the same option if they have different market forecasts and trading styles.

8. CBOE Volatility Index (VIX): The VIX, introduced by CBOE in 1990, measures the Volatility of the U.S. equity market. It provides investors with up-to-the-minute market estimates of expected volatility by using real-time OEX index option bid/ask quotes. This index is calculated by taking a weighted average of the implied volatilities of eight OEX calls and puts. The chosen options have an average time to maturity of 30 days. Consequently, the VIX is intended to indicate the implied volatility of 30-day index options. It is used by some traders as a general indication of index option implied volatility. (Source: CBOE)
9. CBOE NASDAQ Volatility Index (VXN): Like the VIX, the VXN measures implied volatility, but in this case for NASDAQ 100 (NDX) index options, thereby representing an intraday implied volatility of a hypothetical at-the-money NDX option with thirty calendar days to expiration. Both the VXN and the VIX are used as sentiment indicators for the NASDAQ 100 and for the broader market, respectively. Higher readings and spikes generally occur during times of investor panic and at times coincide with market bottoms. Low readings suggest complacency and often occur around tops in index prices.
10. Put / Call Ratio: These ratios are used as contrary sentiment indicators. Higher ratio values, indicating more put trading, is considered more bullish. The CBOE index ratio tracks trade volume of all exchange traded index options, reflecting sentiment of professional and institutional strategies. The CBOE equity ratio is composed of trade volume for individual equity options and a better indicator of retail investor sentiment. Equity ratio readings 60/100 and 30/100 denote levels of bullishness and bearishness. Similarly, bullish and bearish boundaries for the S&P 100 are 125/100 and 75/100.
11. 2-Year Growth of Earnings: Growth of earnings over subsequent 8 quarters. Current observations use forecast of earnings from macro projections.
12. Earnings and Dividend Price Ratios: These ratios represent an investor's yield from earnings and dividend payments. Historically, the EP ratio often has exceeded the real return on bonds, reflecting the greater risk to shareholders for choosing equity investments. Recently, the EP ratio has fallen below the return on bonds as investors demand uncharacteristically large capital gains to compensate for the low earnings yield. Historically, the EP ratio has fallen below the real bond rate only when earnings are expected to rise dramatically.

13. Real Bond Rate: Moody's composite yield of A-rated corporate bonds less the expected rate of inflation over the next 10 years as measured by the consumer price index from the Survey of Professional Forecasters, published by the Federal Reserve Bank of Philadelphia.
14. Moody's Ratings: Denotes the change in dollar amount of investment grade (above BA1) or speculative grade (BA1 or below) securities outstanding for a particular company if that company is up/downgraded during a given month. For example, if company XYZ was upgraded, and they had bonds rated AA2 for \$10, AA1 for \$2, and A3 for \$15, this company's contribution to the chart value is \$27.
15. Investor Expectations: Internally generated composite of the Conference Board's 12-month forward investor expectations for no change, increase, and decrease in the stock market. Composite values of 50 indicate neutral expectations. Values below 50 demonstrate bearish sentiment, though the chart demonstrates that the outlook of investors is typically bullish.
16. Tobin's q: The ratio of the market value of equity plus net interest bearing debt to current value of land, inventories, equipment, and structures.