Money & Investing

Five More Reasons to Buy

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Last month I detailed five things, some of them counterintuitive, that make this a beautiful time to invest in stocks. Here they are: Big bear markets (such as we've had since 2000) tend to be followed by big rallies; people protest too much that economic signs are horrible; the market is fixated on corporate scandals; operating profits are strong despite weak bottom lines; and, finally, high price/earnings ratios are not a predictor of price declines.

But there is ever more beauty. Let's now extend this list of positive indicators. Six: Insider transactions have shifted from bearish to bullish. Normally insiders sell more shares than they buy, as they turn options into spending cash. In bear markets net selling increases. Earlier this year insiders sold about four shares for every one bought. In July that flip-flopped to two shares purchased for every share sold, according to Market Profile Theorems in Seattle. That's an extremely bullish ratio.

Seven: In the steep August rally the total position in shorted stock increased to record levels. Every share sold short, which must eventually be bought back, is a borrowing of future demand for stock, and that is beautiful. That short-selling rose as stocks did is evidence of the skepticism the rally received and normal for a new bull market.

Eight: Small investors exit near market bottoms, and they are exiting right now in droves. In July equity mutual fund redemptions brought the two- and three-month totals to alltime records or near-records. July by itself was the second-biggest month ever in redemptions as a percentage of fund assets, exceeded only by October 1987. This is a beautiful form of capitulation.

Nine: After the midterm congressional elections next month, we soon will enter the sweet spot in the cycle of politics and markets. Almost never is a third year of a president's term a down year. The last time it happened was 1939, and then the S&P 500 was down only 0.4%. The median third-year return of the S&P since inception is 22.8%. Coming right up. Beautiful.

Ten: The long bond's price has been rising. This is basic to new bull markets. Reacting to the bear market rally of April through June 2001--a sucker move most seers mistook for a new bull market--my June 11, 2001 column argued for staying out, detailing why for a new bull market you need the long bond to act well. Ditto for last fall's false rally. Now Treasury bond prices are strong. Yields, that is, are down. Why is this key?

Bonds compete in the capital market with stocks, and in this market a bond's yield corresponds to what is called the earnings yield on a stock. The earnings yield is the inverse of the price/earnings ratio. A P/E of 20, for example, is an earnings yield of 5%--for every $100 you invest, you buy $5 in annual corporate earnings. When bond yields fall, the prior balance between earnings and bond yields is knocked off kilter, pressuring stock prices to rise to return the balance. As the Fed creates new money in a noninflationary world, it goes first to the fixed-income market, buying bonds and driving bond prices up and yields down. It then rebounds into stocks, driving the price up and the earnings yield down.

Here are three ways to participate in the coming bull market:

Occidental Petroleum (nyse: OXY - news - people) (28, OXY, www.oxy.com) has underperformed its industry for years, which is why the stock is cheap now. With rich assets, including 2 billion-plus barrels of reserves, it must shape up or be taken over in a hostile acquisition financed at today's low interest rates. It sells for 90% of annual revenue and 4.6 times cash flow (in the sense of net income plus depreciation).

Selling at a pre-tech-bubble price, **Computer Sciences Corp.** (nyse: CSC - news - people) (30, CSC, www.csc.com) is well run, grows at respectable if not stunning rates and has a near-limitless long-term future in computer-related consulting services. It's cheap at 40% of revenue, 12 times earnings and 3.9 times cash flow. The stock should be trading at 50.

On Wall Street itself, why buy the rest when you can get the best? At 66, down from 135, the price of **Goldman Sachs** (nyse: GS - news - people) (GS, www.gs.com) suggests that the market thinks it's no more than an average broker. It is, in fact, the world's preeminent investment bank. As the stock market rises, Goldman will too. If you don't believe me that the market will rise and you merely want to make a quality bet, buy Goldman and short its competitors. For every $100,000 you buy of Goldman, short $33,000 apiece of the shares of **Bear Stearns** (nyse: BSC - news - people) (58, BSC, www.bearstearns.com), **Legg Mason** (nyse: LM - news - people) (43, LM, www.leggmason.com) and **Nomura Securities** (nyse: NMR - news - people) (12, NMR, www.nomura.co.jp).

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