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Signals say it's time to sell stocks

By Jeff Benjamin

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DETROIT - The so-called smart money seems to be sending equity investors a message that now is a good time to sell stocks, and corporate insiders are leading the way.

Corporate executives have been heading for the exits - dumping their holdings of their own companies' stocks - for most of the year, and that is considered to be one indicator of rough times ahead for the equity markets.

But corporate insiders aren't the only ones feeling skittish about stocks these days.

The latest market sentiment research from Van Hedge Fund Advisors International Inc. showed that hedge fund managers are also turning uncharacteristically bearish as the year winds down.

John Van, chief financial officer of the Nashville, Tenn.-based hedge fund consulting and database firm, said the October survey of hedge fund managers showed bearish sentiment across all three major categories: U.S. equities, the U.S. dollar and the 10-year Treasury note.

This is the first time this year that the monthly survey of hedge fund managers showed a consistently bearish bias in all three categories at the same time.

Mr. Van, like a lot of economists and market watchers these days, said investors were focused primarily on the uncertain status of three big issues: the presidential election, the Iraq war and runaway oil prices.

"If there's one thing the market hates, it's uncertainty," he added.

Exit points

Michael Painchaud, director of research at Market Profile Theorems Inc. in Seattle, said the handwriting has been on the wall all year long, and investors should be taking heed.

"Rather than looking for entry points, investors should be looking for exit points right now," said Mr. Painchaud, who tracks the buying and selling activity of corporate insiders.

He said insider sales have made up more than 72% of total insider transactions for three consecutive weeks, marking one of the most bearish stretches in an already bearish-looking year from an insider-trading perspective.

The general thinking behind the study of insider trading is that if those executives who are closest to the running of a company are selling the stock, it is probably a good indication of where they see the stock heading.

While Mr. Painchaud compared insider activity to the proverbial "canary in the coal mine," he said there are enough things going on right now to reinforce the belief that the near-term outlook for equities is not good.

"If you consider analyst estimates and the ability of companies to meet or beat those estimates, it's clear that corporate earnings will no longer be able to support stock prices at this level," he said. "We're starting to see a plethora of downward revisions and lowered guidance."

Mark Mousseau, a research analyst at Thomson Financial/First Call in Boston, confirmed the trend toward downward revisions.

Of the 242 companies that had pre-announced their third quarters through Wednesday, 132 were downward revisions, 64 were upward revisions, and 46 were neutral.

While the 2-to-1 ratio of negative-to-positive revisions falls into line with the historical average, it reverses three consecutive quarters of a 1-to-1 ratio of negative-to-positive pre-announcements.

Part of what makes the outlook for equities so uncertain is the fact that the economy is running out of stimuli.

Bryan Sadoff, a Milwaukee-based adviser at Sadoff Investment Management LLC, pointed out that the consumer tax cuts of last year have been spent, the mortgage refinancing boom is drying up, and the idea of a no-interest auto loan has lost its luster among car buyers.

"This is a secular bear market, and the stimuli are waning," he said. "This could possibly be another revival of the post-bubble environment that people seem to have forgotten about."

Meanwhile, Mr. Sadoff, whose firm manages more than $300 million, views the glass as half full.

"In terms of what insiders are doing, we might be more interested in their buying than their selling," he said.

Like a lot of market watchers, Mr. Sadoff is torn between the reality of what should be driving the market downward and what should be driving it upward.

"With the exception of oil, we are in a low inflationary environment, we have low taxes, and unemployment is moving in the right direction," he said. "In regard to equities, our bias would be that the economy should improve, and the market should get better."

Oscar Gonzalez, an economist with John Hancock Financial Services Inc. in Boston, also noted the economy's Jekyll-and-Hyde status.

Based on the current levels of corporate profitability and cash flow, he said, the economy appears to be on track for expansion, with economic growth finishing the year at around 4%.

However, Mr. Gonzalez admitted, the calculations for this year and beyond are based on the premise the capital spending by businesses will pick up and take some of the pressure off the consumer.

"Businesses have been investing at a fairly low rate relative to prior expansions, and that is the missing link here," he said. "It's really the portion of the whole macroeconomic outlook that we hope would step in as consumer spending levels off or decreases."

For James Kennedy, an adviser who oversees $35 million, it all adds up to a "watch-and-wait mode."

Mr. Kennedy, president of Marathon Capital Management LLC in Hunt Valley, Md., said the mixed signals have driven him to allocate client accounts to double and triple the normal cash positions.

Mr. Kennedy is looking forward to the conclusion of next month's presidential election.

"I hope the election cleans up a lot of this uncertainty," he said. "Regardless of who is elected, it will give people an idea of what we'll be facing in the next four years."

According to some financial experts, the election could be the last piece of remaining economic stimuli and therefore should produce a short-term market rally.

Charles Gradante, managing principal of the Hennessee Hedge Fund Advisory Group LLC in New York, said the fact that the stock market has not been beaten down severely by the climbing oil prices shows that there is pent-up demand for any kind of good news.

And if only from the perspective of resolving uncertainty, the election will count as good news.

"In spite of everything, the market is still holding at close to 10,000," he said. "That tells me that after the election, we can expect a decent rally."