A Topsy-turvy Transition

As of August 11, 2006

A bumpy ride for the markets this week started with an oil pipeline leak announced by BP(BP), an interest-rate hike paused by the Fed, and then a terrorist plot on US-bound airplanes foiled by British authorities. Despite these fluctuation triggering events, the markets showed mixed and unconventional responses. For the week, the Dow fell 1.4%, the S&P 500 dropped 1%, and the Nasdaq rose 1.3% thanks to the midweek excitement on Cisco's (CSCO) strong earning report. On the bond market, all yields climbed higher this week due to the Fed's dovish pause and weak auctions of the new treasuries. The 10-year Treasury note yielded 4.97%, up from 4.90% last week.

As for crude oil, an even bumpier ride ($3 dollar fluctuation) occurred throughout the week. The price jumped to over $77 per barrel when BP, who provides 8% of US overall oil supply, reported its Alaskan pipeline interruption on Monday. When the terrorist card flashed out again on Thursday, crude oil immediately lost its ground and ended at $74. Moreover, the stock market demonstrated its resilience despite the most startling terrorism news since 9/11. All three major indices were up. This was partially because of a relief from the oil price but it might also suggest that Wall Street is becoming accustomed to dealing with terrorist risks.

In contrast to the markets' reactions on the terrorist news, the Fed's pause on short-term interest rate at 5.25% after 17 consecutive rate hikes failed to cheer the markets up. Both stock and bond markets were up a little bit right after the announcement but then the markets went south until the closing bell. While the Fed was hoping the previous monetary tightening actions would moderate inflation, investors were more concerned about the slowing economy, especially a slowdown in the housing market.

Since July, the Dow Jones U.S. Home Construction Index (DJUSHB) was down 46%. On Wednesday, luxury home builder, Toll Brothers, Inc.(TOL.N) reported a 47% slide on new orders. The hit was not only limited to the luxury market, D.R. Horton Inc. (DHI.N), the largest U.S. home builder, also took a plunge on July's new orders. A chain reaction was observed when the shares of home improvement chains such as Home Depot Inc. (HD.N) and Lowe's Cos. (LOW.N) fell more than 2% each. On top of these sliding numbers, housing prices also dropped due to an oversupply of homes on the market, especially from the speculators who have been trying to unload their investments. With these mounting evidences vindicating that we are in the beginning of a cooling housing market, how big the impact is going to be on the markets in general, especially during this transitional stage, will be a crucial concern for the investors.

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In addition to the housing market concern, geopolitics should also be on investors' monitor list. In the long run, Aerospace and Defense industry stocks can be potential buys for investors. The high possibility of the Democrats taking over Congress in November's election and Joe Lieberman's defeat by the anti-war opponent in the state's Democratic primary election may have caused the drop in defense stocks since May. However, the ongoing conflicts between the Israeli and the Hezbollah are not likely to be resolved in the short run. Since a powerful Shia-led government took over Iran, Iraq, and Hezbollah, the tension between the Shias and the Sunnis (pro-U.S.) might ignite a civil war and worsen the situation in the Middle East. Individual stocks such as United Technologies (UTX), Northrop Grumman (NOC), Boeing (BA), Lockheed Martin (LMT), General Dynamics (GD), Raytheon (RTN), and Rockwell Collins (COL) may come back strong in the longer term. Investors can also buy ETF such as PowerShares Aerospace & Defense (PPA), especially when it goes down below $15.

Now that the Fed is out the way and earning season is winding down, the markets are heading toward a changing stage but without a clear driving force. As a result, investors may witness paradoxical reactions from the markets during this period of time. Although many uncertainties lie ahead for the markets, stocks are still relatively cheaper than bonds since the P/E ratio of S&P 500 has remained low at around 14. On the bond side, short-term treasuries such as 2-year notes might be a better choice for the investors. Overall, it is a busy season for the money manager.