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Low-quality market rally ripe for a reversal, observers say

Staying power of riskier stocks that are leading the rise is in question

By **Dan Jamieson**
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The market's recent rally is likely to be short-lived.

Since the closing low on March 9, the markets have been led higher by lower-quality stocks and riskier asset classes, such as financial stocks and emerging-market equities.

“I don't think the rally can continue forever on the basis of low quality,” said Robert Doll, the global chief investment officer of equities at BlackRock Inc. of New York.

Market watchers say that it is typical for sectors that sold off the most during a downturn to bounce back the strongest during an initial rebound.

But a new, long-term secular bull market would most likely require new leadership from more attractive industries, market observers said.

“Normally, in a healthy environment, it's the leaders leading the charge, and the laggers are along for the ride. If this were a real bull market, we'd [see leadership] from all the quality companies at some point, the ones with real earnings that did not need a bailout and don't need to raise capital,” said Peter Mauthe, president of Rhoads Lucca Capital Management Inc. in Dallas, which manages $120 million.

Peter Mauthe: *If the rally were real, quality companies would be leading.*

"Those stocks have not been leading; that's what is peculiar so far," said Mr. Mauthe, who is also president of the American Association of Professional Technical Analysts Inc. in Chicago.

The three top-performing open-end funds, from March 9 to May 12, were financial-sector funds with a 62.94% return; Latin America funds were up 56.06%, and global real estate funds returned 50.27%, ac-cording to Chicago-based Morningstar Inc.

By contrast, the Standard & Poor's 500 stock index gained 34.77%, according to Bespoke Investment Group LLC, a Harrison, N.Y.-based research firm.

Bloomberg

Robert Doll: *The lower the quality, the better the stock has done.*

Based on a quality measure it created that factors in leverage, earnings stability, valuation and stock-price volatility, BlackRock has analyzed stocks in the S&P 500 and found that since March 9, quality and performance are "perfectly correlated: the lower the quality, the better [the stock has] done," Mr. Doll said.

Those who think the rally is nothing more than a head fake have a great deal of company.

New areas of leadership could emerge at any time. One better-quality sector that has done well is technology, a favorite sector of many advisers because tech companies typically have low debt and an ability to grow in a turnaround, observers say.

Another favorite, health care, has not kept pace with the recent rally, though the sector was doing well as the market sold off late last week.

"Sometimes, these bounces off the bottom ... do morph into more bullish environments," said Gary Anderson, publisher of the Equity Portfolio Manager newsletter in Eugene, Ore. He is nevertheless skeptical of the rally until a longer-term trend develops.

This time, trends are taking longer than normal to develop, Mr. Mauthe said.

Usually, within the first week or two of a new rally, short covering of lagging stocks often drives them higher, he said. "But that quickly abates when real investor capital comes in."

In this environment, the big losers may have gotten an extra strong bounce.

Amid the downturn, financial companies and home builders faced questions about their very survival, Mr. Doll said. Perceptions changed quickly when the market rallied and the financing window for these stressed firms opened up, he said.

"Companies that looked terminal, or potentially terminal, all of a sudden now look like they're just low-quality companies," and as a result their stock prices have rallied strongly, Mr. Doll said.

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