

Framework of Analysis

- Fundamental Analysis
- Approach to Fundamental Analysis:
 - Domestic and global economic analysis
 - Industry analysis
 - Company analysis
- Why use the top-down approach?

Global Economic Considerations

- Performance in countries and regions is highly variable.
- Political risk
- Exchange rate risk
 - Sales
 - Profits
 - Stock returns

Table 17.1 Economic Performance in Selected Emerging Markets

TABLE 17.1

Economic performance
in selected emerging
markets

	Growth in Real GDP	Stock Market Return	
		Local Currency	\$ Terms
Argentina	9.2	12.9	11.3
Brazil	1.4	17.1	28.1
China	9.9	12.2	12.7
Colombia	5.8	17.5	19.6
Hong Kong	7.6	6.3	6.3
India	7.6	12.4	14.0
Indonesia	4.9	6.6	14.2
Mexico	2.7	7.1	8.8
Russia	7.0	25.7	28.9
Singapore	8.7	5.8	8.7
South Africa	4.5	5.5	8.3
South Korea	5.2	-0.6	3.5
Taiwan	6.4	1.0	2.8
Turkey	7.0	19.4	23.4
Venezuela	10.2	42.8	42.1

Source: *The Economist*, March 4, 2006. © 2006 The Economist Newspaper Group, Inc. Reprinted with permission. Further reproduction is prohibited. www.economist.com. All rights reserved.

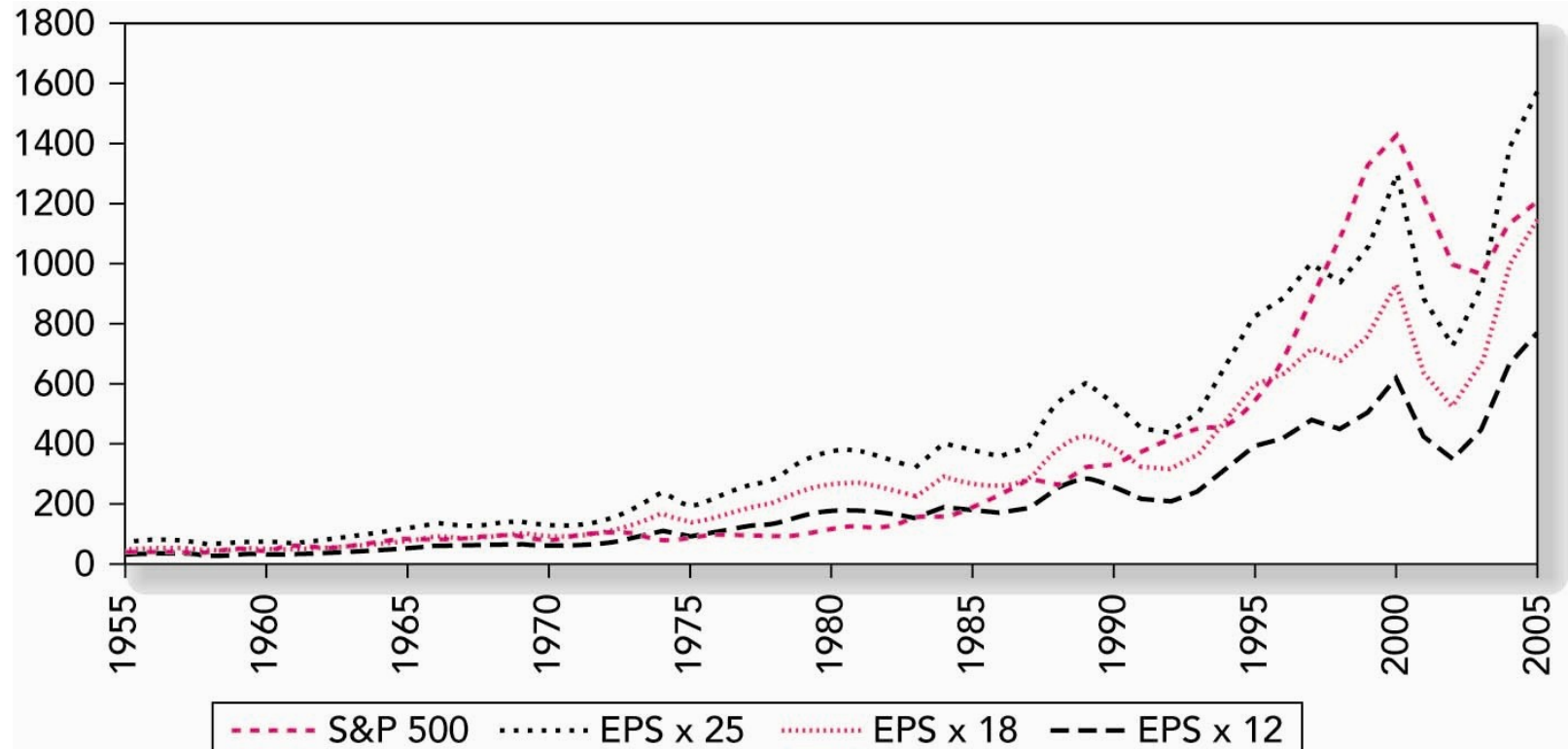
Figure 17.1 Change in Real Exchange Rate: Dollar versus Major Currencies, 1999 – 2005



Key Economic Variables

- Gross domestic product
- Unemployment rates
- Interest rates & inflation
- Budget deficit
- Consumer sentiment

Figure 17.2 S&P 500 Index versus Earnings Per Share Estimate



Demand Shocks

- *Demand shock* - an event that affects demand for goods and services in the economy.
 - Tax rate cut
 - Increases in government spending

Supply Shocks

- *Supply shock* - an event that influences production capacity or production costs.
 - Commodity price changes
 - Educational level of economic participants

Federal Government Policy

- *Fiscal Policy* - government spending and taxing actions.
 - Direct policy
 - Slowly implemented

Federal Government Policy (cont'd)

- Monetary Policy - manipulation of the money supply to influence economic activity.
 - Initial & feedback effects
 - Tools of monetary policy
 - Open market operations
 - Discount rate
 - Reserve requirements
- Supply Side Policies

NBER Cyclical Indicators: Leading

Leading Indicators - tend to rise and fall in advance of the economy.

Examples:

- Avg. weekly hours of production workers
- Stock Prices

NBER Cyclical Indicators: Coincident

Coincident Indicators - indicators that tend to change directly with the economy.

Examples:

- Industrial production
- Manufacturing and trade sales

NBER Cyclical Indicators: Lagging

Lagging Indicators - indicators that tend to follow the lag economic performance.

Examples:

- Ratio of trade inventories to sales
- Ratio of consumer installment credit outstanding to personal income

Figure 17.3 Cyclical Indicators

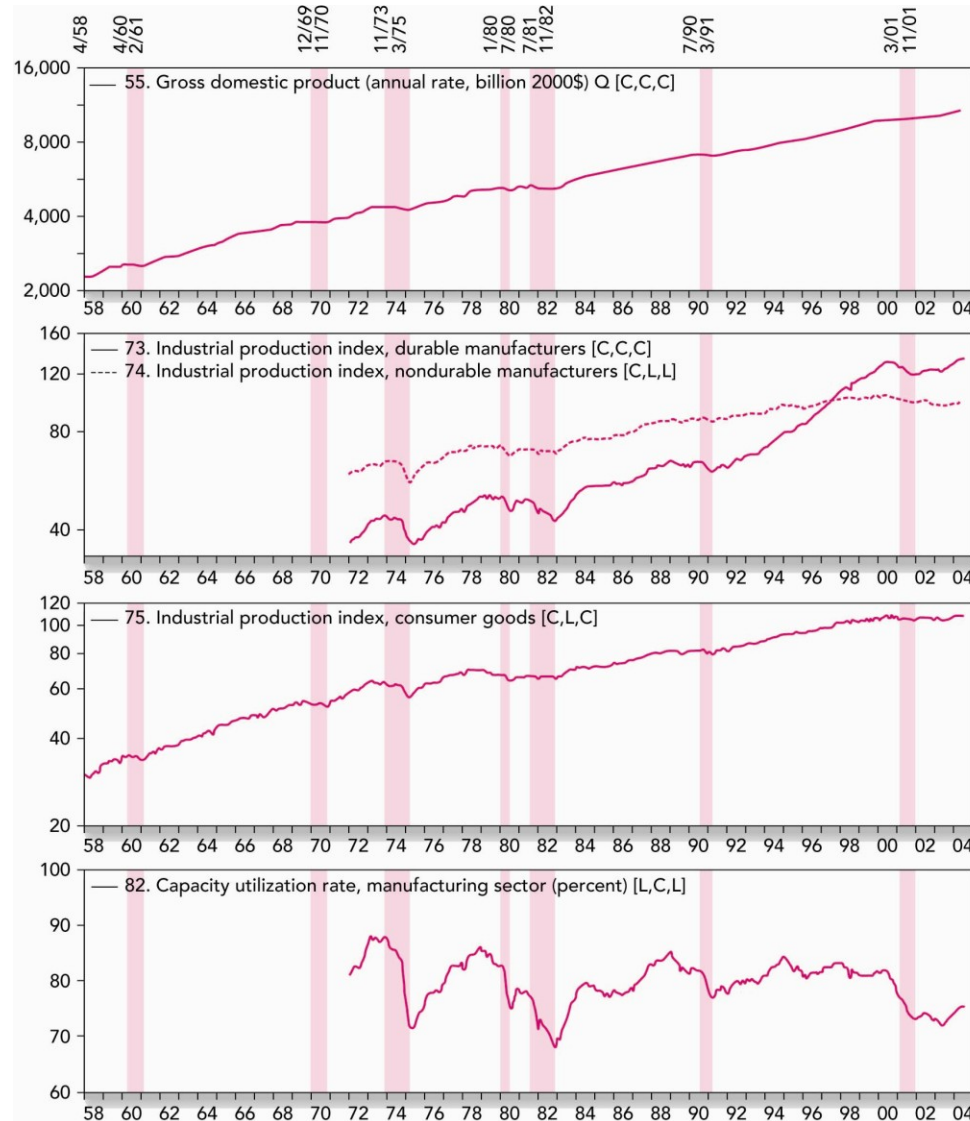


Table 17.2 Indexes of Economic Indicators

A. Leading indicators
1. Average weekly hours of production workers (manufacturing)
2. Initial claims for unemployment insurance
3. Manufacturers' new orders (consumer goods and materials industries)
4. Vendor performance—slower deliveries diffusion index
5. New orders for nondefense capital goods
6. New private housing units authorized by local building permits
7. Yield curve slope: 10-year Treasury minus federal funds rate
8. Stock prices, 500 common stocks
9. Money supply (M2)
10. Index of consumer expectations
B. Coincident indicators
1. Employees on nonagricultural payrolls
2. Personal income less transfer payments
3. Industrial production
4. Manufacturing and trade sales
C. Lagging indicators
1. Average duration of unemployment
2. Ratio of trade inventories to sales
3. Change in index of labor cost per unit of output
4. Average prime rate charged by banks
5. Commercial and industrial loans outstanding
6. Ratio of consumer installment credit outstanding to personal income
7. Change in consumer price index for services

TABLE 17.2

Indexes of economic indicators

Source: The Conference Board, *Business Cycle Indicators*, February 2006.

Figure 17.4 Indexes of Leading, Coincident and Lagging Indicators

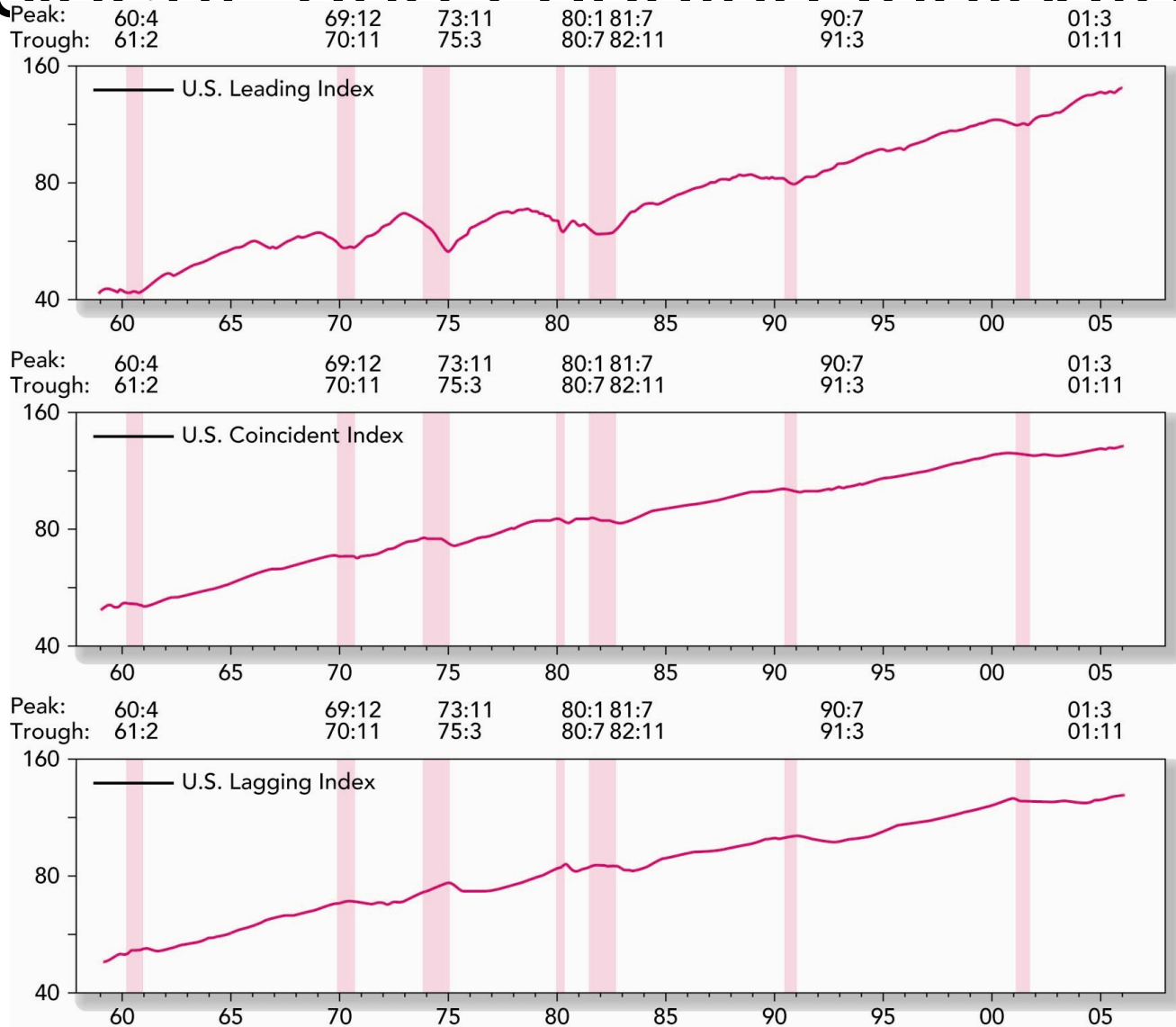


Table 17.3 Economic Calendar

Statistic	Release Date*	Source	Web Site
Auto and truck sales	2nd of month	Commerce Department	commerce.gov
Business inventories	15th of month	Commerce Department	commerce.gov
Construction spending	1st business day of month	Commerce Department	commerce.gov
Consumer confidence	Last Tuesday of month	Conference Board	conference-board.org
Consumer credit	5th business day of month	Federal Reserve Board	federalreserve.gov
Consumer price index (CPI)	13th of month	Bureau of Labor Statistics	bls.gov
Durable goods orders	26th of month	Commerce Department	commerce.gov
Employment cost index	End of first month of quarter	Bureau of Labor Statistics	bls.gov
Employment record (unemployment, average workweek, nonfarm payrolls)	1st Friday of month	Bureau of Labor Statistics	bls.gov
Existing home sales	25th of month	National Association of Realtors	realtor.org
Factory orders	1st business day of month	Commerce Department	commerce.gov
Gross domestic product	3rd–4th week of month	Commerce Department	commerce.gov
Housing starts	16th of month	Commerce Department	commerce.gov
Industrial production	15th of month	Federal Reserve Board	federalreserve.gov
Initial claims for jobless benefits	Thursdays	Department of Labor	dol.gov
International trade balance	20th of month	Commerce Department	commerce.gov
Index of leading economic indicators	Beginning of month	Conference Board	conference-board.org
Money supply	Thursdays	Federal Reserve Board	federalreserve.gov
New home sales	Last business day of month	Commerce Department	commerce.gov
Producer price index	11th of month	Bureau of Labor Statistics	bls.gov
Productivity and costs	2nd month in quarter (approx. 7th day of month)	Bureau of Labor Statistics	bls.gov
Retail sales	13th of month	Commerce Department	commerce.gov
Survey of purchasing managers	1st business day of month	Institute for Supply Management	ism.ws

TABLE 17.3

Economic calendar

*Many of these release dates are approximate.

Source: Briefing.com, 2006.

Figure 17.5 Economic Calendar at Yahoo!

Economic Calendar

Week of March 13, 2006

Last Week

Next Week

Date	Time (ET)	Statistic	For	Actual	Briefing Forecast	Market Expects	Prior	Revised From
Mar 14	8:30 AM	Current Account	Q4	-\$224.9B	-\$217.0B	-\$218.0B	-\$185.4B	-\$195.8B
Mar 14	8:30 AM	<u>Retail Sales</u>	Feb	-1.3%	-0.7%	-0.9%	2.9%	2.3%
Mar 14	10:00 AM	<u>Business Inventories</u>	Jan	0.4%	0.1%	0.3%	0.8%	0.7%
Mar 15	9:00 AM	Net Foreign Purchases	Jan	\$66.0B	NA	NA	\$53.8B	\$56.6B

Table 17.4 Useful Economic Indicators

CEO polls www.businessroundtable.org	The business roundtable surveys CEOs about planned capital spending, a good measure of their optimism about the economy.
Temp jobs (search for "Temporary Help Services") www.bls.gov	A useful leading indicator. Businesses often hire temporary workers as the economy first picks up, until it is clear that an upturn is going to be sustained. This series is available at the Bureau of Labor Statistics Web site.
Wal-Mart sales www.walmartstores.com	Wal-Mart sales are a good indicator of the retail sector. It publishes its same-store sales weekly.
Commercial and industrial loans www.federalreserve.gov	These loans are used by small and medium-sized firms. Information is published weekly by the Federal Reserve.
Semiconductors www.semi.org	The book-to-bill ratio (i.e., new sales versus actual shipments) indicates whether demand in the technology sector is increasing (ratio > 1) or falling. This ratio is published by Semiconductor Equipment and Materials International.
Commercial structures www.bea.doc.gov	Investment in structures is an indicator of businesses' forecasts of demand for their products in the near future. This series is compiled by the Bureau of Economic Analysis as part of its GDP series.

TABLE 17.4

Useful economic indicators

Industry Analysis

- Sensitivity to business cycles
- Factors affecting sensitivity of earnings to business cycles:
 - Sensitivity of sales of the firm's product to the business cycles
 - Operating leverage
 - Financial leverage
- Industry life cycles

Figure 17.6 Returns on Equity, 2005

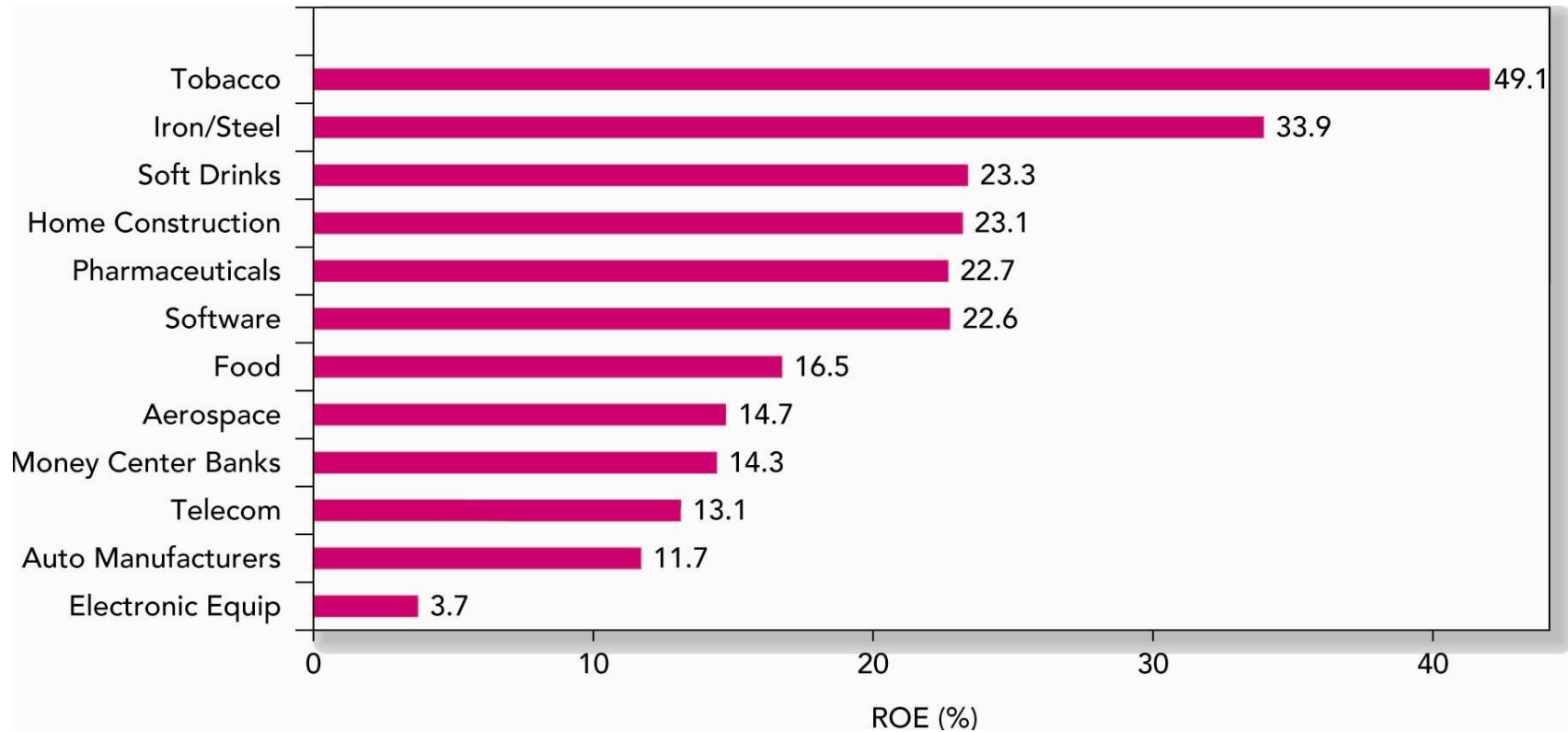


Figure 17.7 Rate of Return, 2005

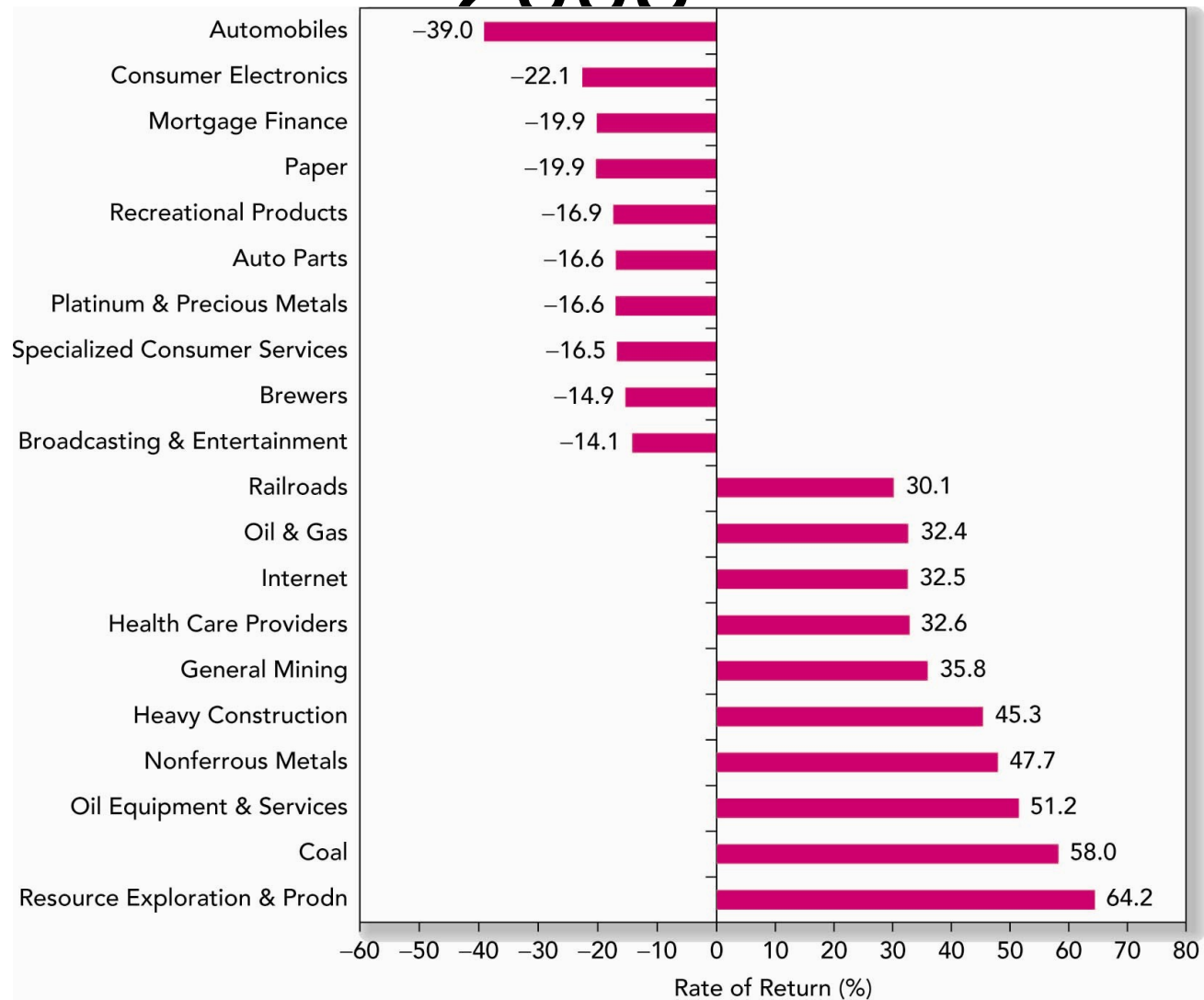


Figure 17.8 ROE of Money Center Banks

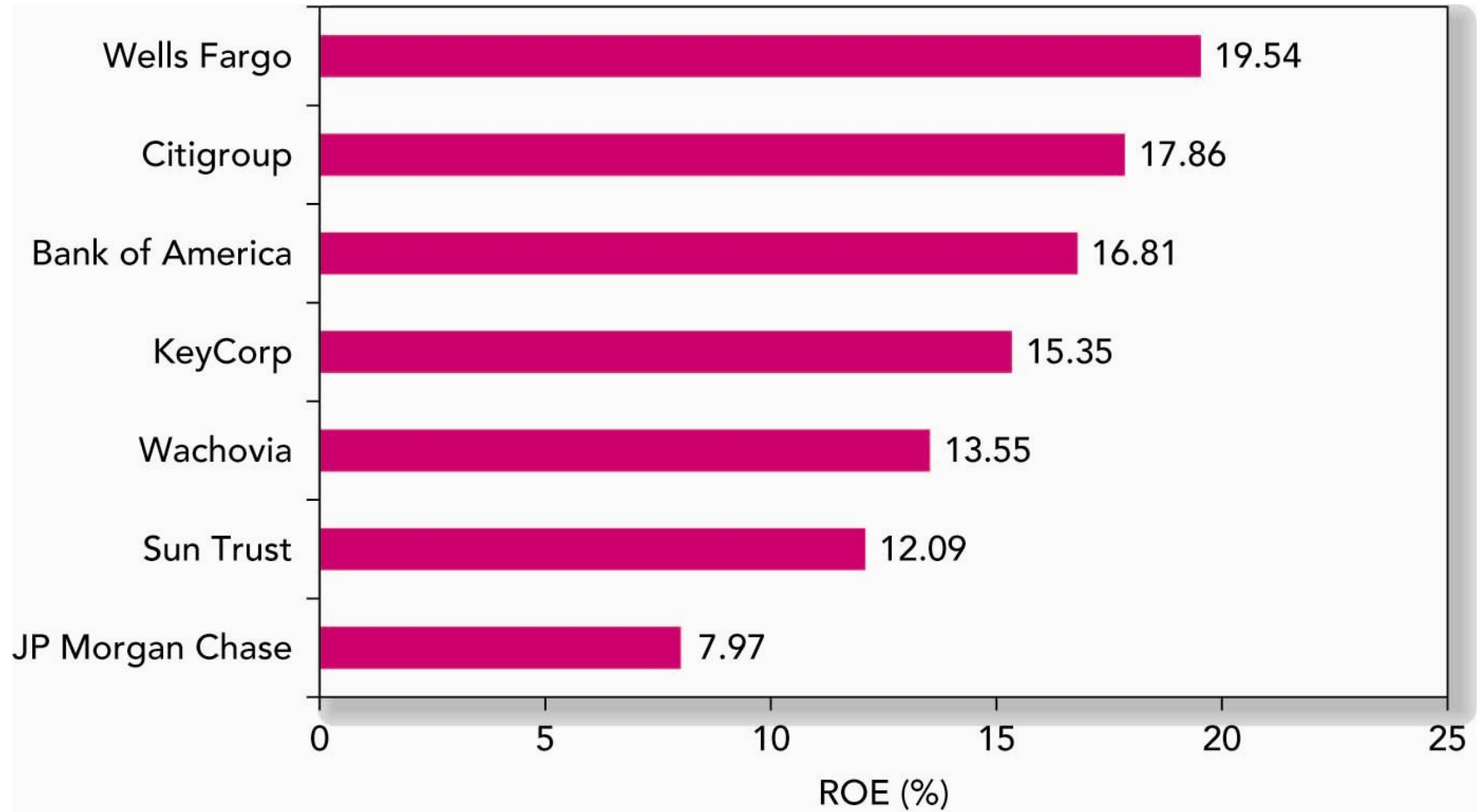


Table 17.5 Examples of NAICS Industry Codes

NAICS Code	NAICS Title
23	Construction
236	Construction of Buildings
2361	Residential Building Construction
23611	Residential Building Construction
236115	New Single-Family Housing Construction
236116	New Multifamily Housing Construction
236117	New Housing Operative Builders
236118	Residential Remodelers
2362	Nonresidential Building Construction
23621	Industrial Building Construction
236210	Industrial Building Construction
23622	Commercial and Institutional Building Construction
236220	Commercial and Institutional Building Construction

TABLE 17.5

Examples of NAICS industry codes

Figure 17.9 Industry Cyclicality

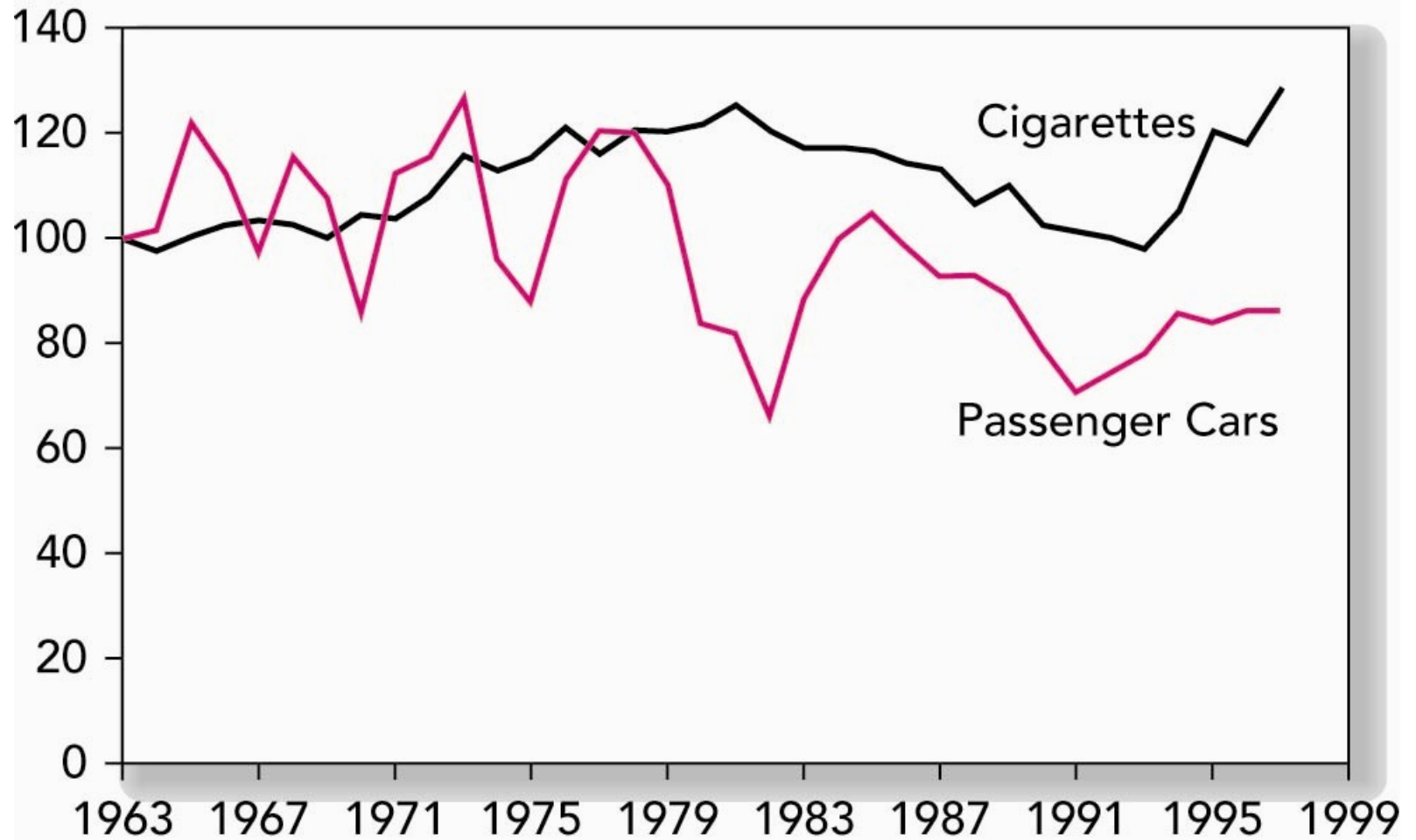


Table 17.6 Operating Leverage of Firms A and B Throughout the Business Cycle

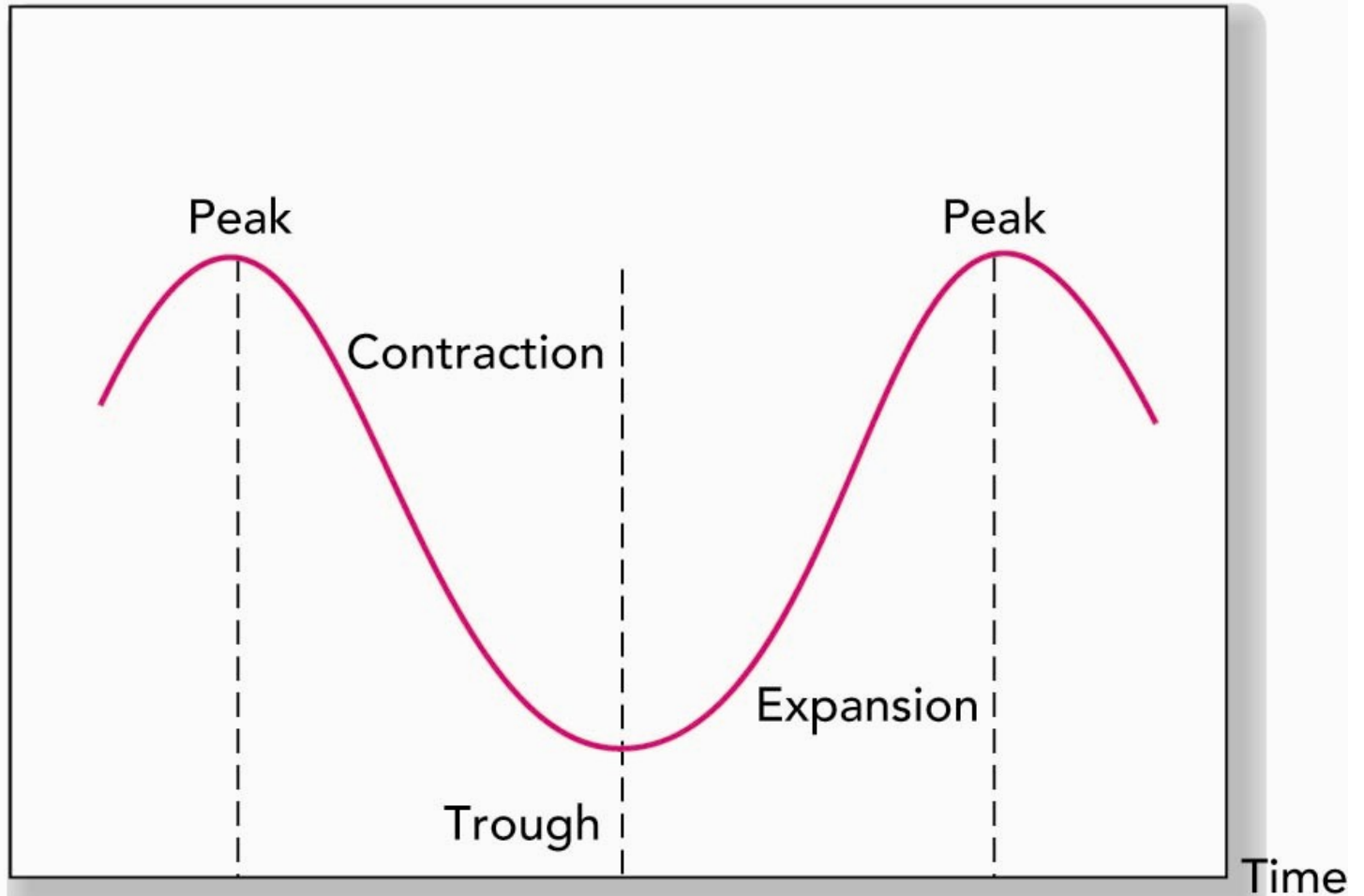
	Recession		Normal		Expansion	
	A	B	A	B	A	B
Sales (million units)	5	5	6	6	7	7
Price per unit	\$ 2	\$ 2	\$ 2	\$ 2	\$ 2	\$ 2
Revenue (\$ million)	10	10	12	12	14	14
Fixed costs (\$ million)	5	8	5	8	5	8
Variable costs (\$ million)	5	2.5	6	3	7	3.5
Total costs (\$ million)	\$10	\$10.5	\$11	\$11	\$12	\$11.5
Profits	\$ 0	\$ (0.5)	\$ 1	\$ 1	\$ 2	\$ 2.5

TABLE 17.6

Operating leverage of firms A and B throughout business cycle

Figure 17.10 A stylized Depiction of the Business Cycle

Economic Activity



Industry Life Cycles

Stage

Start-up

Consolidation

Maturity

Relative Decline

Sales Growth

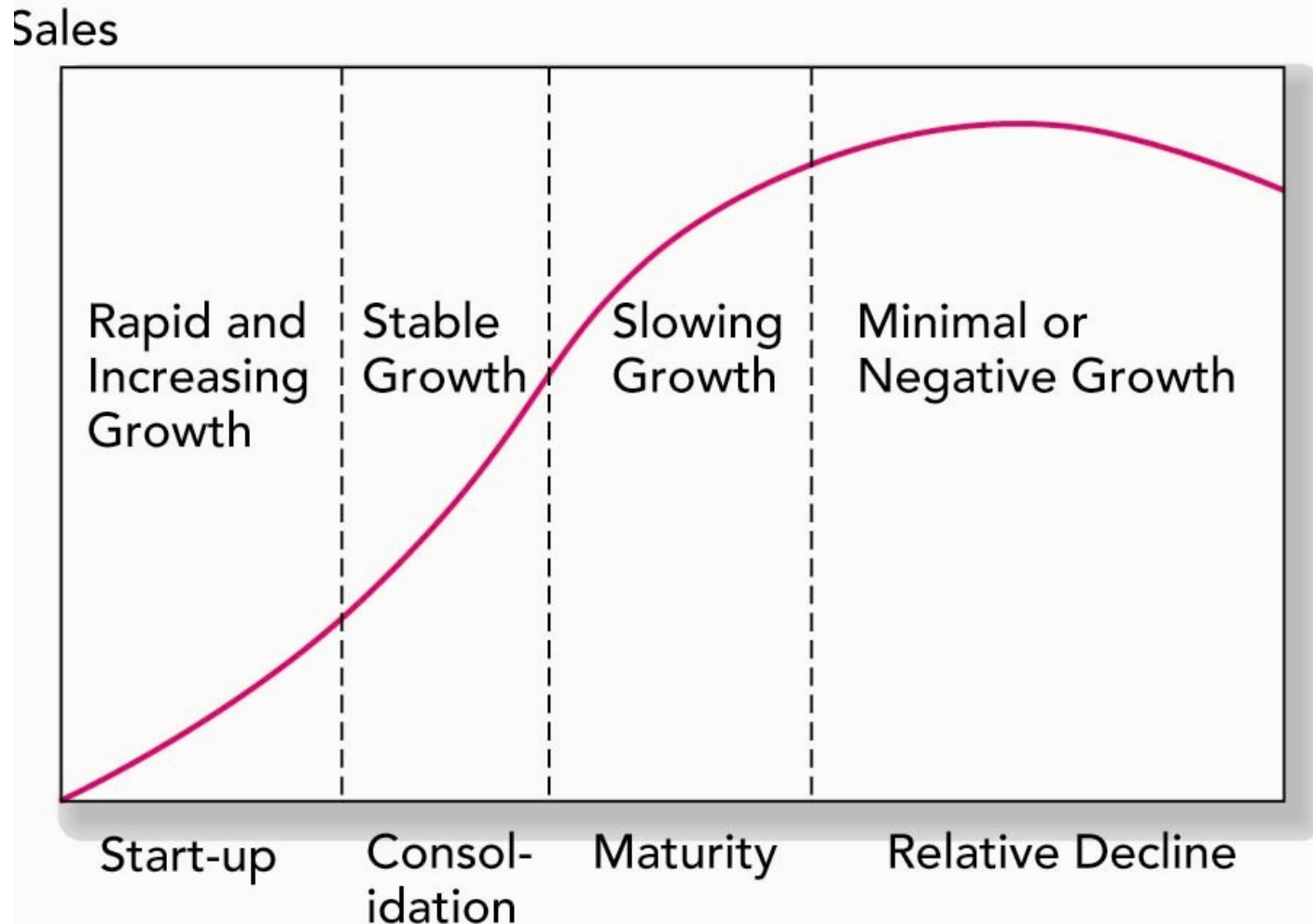
Rapid & Increasing

Stable

Slowing

Minimal or Negative

Figure 17.11 The Industry Life Cycle



Sector Rotation

- Portfolio is adjusted by selecting companies that should perform well for the stage of the business cycle
 - Peaks – natural resource extraction firms
 - Contraction – defensive industries such as pharmaceuticals and food
 - Trough – capital goods industries
 - Expansion – cyclical industries such as consumer durables