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MarketShadows

this issue

Event Horizon

[P/E 10 as a Valuation Gauge = In-complete Information](link)

By [Paul Price](link) (Originally published on [The Street's Real Money Pro](link))

The P/E 10 is used to 'smooth out' shorter-term (year–to-year) fluctuations in total S&P 500 corporate profits. It does not use 'adjusted' earnings (which eliminate non-recurring items).

This is how the P/E 10 looks right now compared with where it has been since 2003. The historical middle quintile for P/E 10 ratios has been 14.3x – 17.3x.

Chart Source: Y Charts

At a glance, today's 20.36x doesn't look cheap, except when compared with the pre-recession period.

Computer screens don't take into account when outlier data points need to be thrown out.

In 2009 an unprecedented spike in P/E resulted from the enormous write-offs that occurred in the financial sector. That year's trailing P/E multiple did not represent investor enthusiasm. It registered high because earnings fell dramatically (massive, one time non-recurring losses greatly reduced "earnings"). As such, the 2009 number was totally not meaningful (NMF).

Published P/E 10 figures include that 123.7 P/E in their calculations. While technically correct, this turns all smoothed data into apples-to-oranges comparisons.

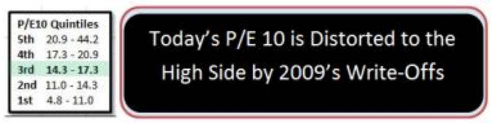
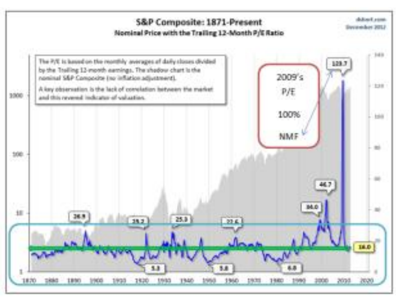


Chart Source: dshort.com Commentary: Dr. Paul Price

Clearly P/E 10s of 25x – 27.5x were flashing warning signals from 2004 through 2007. That was a message that should have triggered caution.

Here is the chart of Trailing 12-Month P/Es – this shows single-year P/Es without the 2009 result tainting subsequent years.



Basic Chart Source: dshort.com Additional Highlights Source: Dr. Paul Price

More at this link.

"Gambling: The sure way of getting nothing for something."

Wilson Mizner

Catch-22

Catch-22 is a satirical and somewhat historical novel by the American author Joseph Heller. He began writing it in 1953, and the novel was first published in 1961. It is set during World War II in 1943 and is frequently cited as one of the great literary works of the twentieth century. It uses a distinctive non-chronological third-person omniscient narration, describing events from different characters' points of view and out of sequence so that the time line develops along with the plot.

The novel follows Captain John Yossarian, a U.S. Army Air Forces B-25 bombardier. Most of the events in the book occur while the fictional 256th squadron is based on the island of Pianosa, in the Mediterranean Sea west of Italy. The novel looks into the experiences of Yossarian and the other airmen in the camp, and their attempts to keep their sanity in order to fulfill their service requirements, so that they can return home. The phrase "Catch-22", "a problematic situation for which the only solution is denied by a circumstance inherent in the problem or by a rule," has entered the English language.

Source: Wikipedia.com

(Click on charts to enlarge)

Market-Moving Forces

For Stocks, Plenty of Cash But The Will To Commit It Has Been Lacking

From Market Shadows Newsletter: Market Moving Forces

Lee Adler of the Wall Street Examiner noted in "Fed Creates Nightmare Scenario, Closes Eyes, Sings Trololo" that on Dec. 12, the Federal Reserve elected to print an additional $45 billion a month via outright purchases of Treasuries.

> *That's in addition to the printing of $40 billion a month via Mortgage Backed Securities (MBS) purchases that it is already doing. It will also continue to reinvest the proceeds of maturing MBS. That's been running at $35-$40 billion per month. At that rate the Fed will be pumping at least $120 billion per month into the trading accounts of the Primary Dealers. This total is as high as during QE 1 in 2009. The dealers will use the cash to purchase more Treasuries, which will partly fund the Treasury debt. Other buyers will continue to fund the rest.*

Primary dealers are investment banks which serve as trading counterparties of the New York Fed in its implementation of monetary policy. For example: Goldman Sachs, HSBC Securities, J.P. Morgan and Morgan Stanley (list here). In addition to purchasing more Treasuries with cash from the Fed, the Primary Dealers may buy MBS, stocks and commodities.

Lee surmised that the Fed created a "Catch 22" for itself by tying the Fed Funds rate to inflation, as it decided to keep the target range for the federal funds rate at 0 to 1/4 percent for as long as the unemployment rate remains above 6-1/2 percent with inflation no more than a half percentage point above its 2 percent goal. The Fed is not anticipating inflation to exceed 2%, as it measures it. However, we have argued that the Fed's measures are flawed and/or manipulated. Lee wrote:

> *…The Fed governors and bank presidents didn't see inflation surpassing 2%, EVER.*
>
> *But what if, as I think highly likely, commodity prices surge as a result of this new round of money printing. Normally, in the short run, commodity price rises do not filter into the inflation measures which the Fed watches. Commodity price inflation could rage without pushing the PCE and core PCE to anywhere near the 2.5% threshold the Fed has set.*
>
> *That has the potential to wreak havoc in the economy without raising employment levels at all. Manufacturers, middlemen and consumers would be squeezed by rising food and energy costs well before the Fed had any inkling of an increase in the tortoise-like PCE measures. The cost squeeze would force consumers to cut back on spending, and manufactures, distributors and retailers to cut back on employment. Inflation would stop economic growth, all the while the Fed is peering into its crystal balls a year or two ahead and seeing no inflation.*
>
> *Then, as the economy ground to a halt, what would the Fed do? Stop QE because commodity inflation was crushing the economy? That would run the risk of exacerbating the contraction. Print even more money, driving commodities up even faster? In truth, if commodities do go into bull mode, the Fed would seem to have no way out.*

In the meantime, Lee notes that more cash from the Fed will be injected into system next week. So while the market didn't celebrate Fed giving money to the Primary Dealers last week, it still can. There's enough cash to power that Christmas rally we've been waiting for. (For Stocks, Plenty of Cash But The Will To Commit It Has Been Lacking – Professional Edition)

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Get regular updates the machinations of the Fed, Treasury, Primary Dealers and foreign central banks in the US market, in the Fed Report in the Professional Edition, Money Liquidity, and Real Estate Package. Click this link to try WSE's Professional Edition risk free for 30 days!

Chart Art

[China Breaks Up]

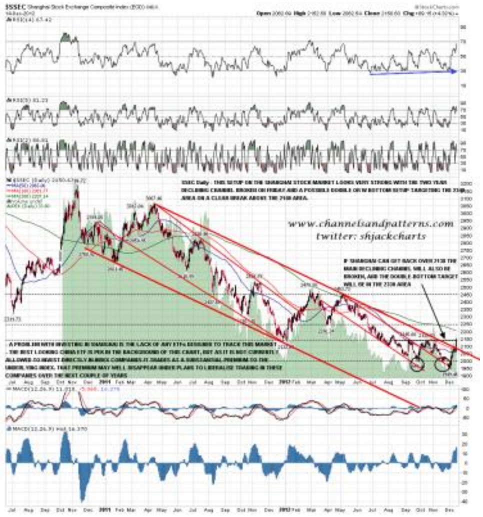
Chart Art by Richard Chappell (Springheel Jack)

We have a trend-less market at the moment – a stock picker's market. But I'm still leaning bullish into 2013. On US equities, the P/E ratios are reasonable by historical standards and asset prices are being actively supported by the Fed. According to Barron's, the market isn't expensive and there's room to expand, particularly if investor confidence improves. Profit margins are high by historical standards.

The Russell 2000 illustrates the technical backdrop. On the seven-year chart below, there is strong resistance not far above in the 868 area. There are two double-tops on the chart, the first indicating back to the 600 area on a break below the June low at 730, and the second pointing back to the 2009 lows on a conviction break below the 2011 low at 602. The upside looks limited, unless RUT breaks above the resistance zones of the 2007, 2011 and 2012 highs.

An old market truism is that there is always a bull market somewhere. A prime candidate for a new one is China's Shanghai Composite Index (SSEC). There are signs that the brutal bear market of the last few years may be over. The declining channel from the 2011 high broke up on Friday, and there's a double or W bottom target in the 2330 area. The daily chart below shows the channel break on Friday. If this break higher holds, my target is in the 2650 area (see chart above right)

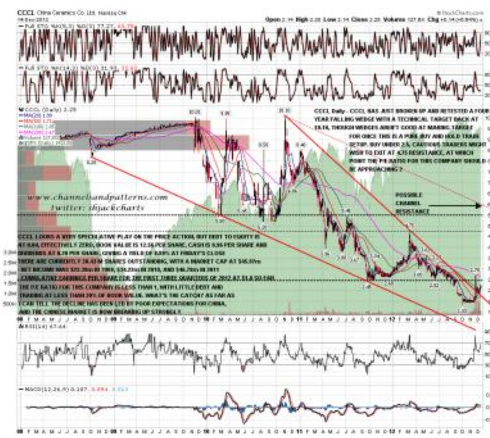
Ceramics Co., Ltd. (CCCL, $2.25) is an interesting "gambling-money" play that might find some love if China's upturn continues. Based in China, CCCL is a manufacturer of ceramic tiles. It trades on the Nasdaq Capital Market for small caps, having gained US listing via a reverse merger – i.e., the company bought a publicly traded shell



corporation. It has just broken up from a falling wedge, and has retested the broken wedge trend-line. Its fundamentals look good too (or too good?).

According to Yahoo finance, there are 20.43m shares of CCCL outstanding and 50% of those are owned by insiders. The P/E ratio is 1.0. The dividend at 0.20 per share is currently yielding 8.9%. The market capitalization is $45.97m and net income was $22.391m in 2009, $34.216m in 2010, $46.781m in 2011. Non-GAAP net profit (excluding employee compensation expenses) has been $34.7m for the first three quarters of 2012. This company has maintained profits in a very difficult property market. CCCL looks undervalued, and if equities in China have bottomed, these shares may be an attractive way to play a China recovery.

The trade setup is to buy a small position in CCCL under $2.50 and hold it. My target is $10. I would sell half at $4.7, just under the resistance zone between $4.75 and $5.5, and set a stop on the remainder at the entry level. Here is the CCCL daily five year chart:



More at this link.

Generally Accepted Accounting Principles (United States)

In the United States, Generally Accepted Accounting Principles are accounting rules used to prepare, present and report financial statements for a wide variety of entities, including publicly traded and privately held companies, non-profit organizations, and government authorities. The term is usually confined to the United States; where it is commonly abbreviated as US GAAP or simply GAAP. However, theoretically, Generally Accepted Accounting Principles encompass all accepted rules which generally apply to accountancy, and not only the United States.

Like many other common law countries, the United States government does not directly set accounting standards by statute. However, the U.S. Securities and Exchange Commission (SEC) requires that US GAAP be followed in financial reporting by publicly traded companies. Currently, the Financial Accounting Standards Board (FASB) establishes generally accepted accounting principles for public and private companies, as well as for non-profit organizations. For local and state governments, the Governmental Accounting Standards Board (GASB) determines the GAAP which operate using a set of assumptions, principles, and constraints, different from those of standard private-sector GAAP. The Federal Accounting Standards Advisory Board (FASAB) regulates the financial reporting standards in federal government entities.

The US GAAP provisions differ somewhat from International Financial Reporting Standards (IFRS), though former SEC Chairman Christopher Cox set out a timetable for all U.S. companies to drop GAAP by 2016, with the largest companies switching to IFRS as early as 2009.

The FASB expressed US GAAP in XBRL beginning in 2008.

Source: Wikipedia.com

(Click on charts to enlarge)

Spring-heeled Jack

Spring-heeled Jack is a character in English folklore of the Victorian era who was known for his startling jumps. The first claimed sighting of Spring-heeled Jack was in 1837. Later sightings were reported all over England and were especially prevalent

Exploration of Equities

MMM: Post-Its and Magic Tape Could Stick the Landing

Courtesy of Dr. Paul Price

It's hard to go wrong over the long-term with shares of a high-quality, predictable growth stock. That's especially true when it sports an A++ balance sheet and provides a 2.56% current yield.

Diversified manufacturer MMM now trades near its best (read: lowest) multiple in a couple of decades, excepting the 2008-09 low. 3M's yield is similarly higher than its average distribution rate in the most recent 10 years.

3M Company 2002 – 2011 Annual Average P/E and Yield

2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	10-year average	
24.4	22.8	21.9	18.9	15.2	15.0	14.6	14.1	14.5	14.5	17.6x	Avg Ann'l P/E Ratio
2.0%	1.9%	1.8%	2.2%	2.4%	2.3%	2.8%	3.2%	2.5%	2.5%	2.36%	Avg Ann'l Div'd Yield

Dec. 16, 2012 P/E = 13.5x 2013 estimate of $6.84 Yield = 2.56%

Sources: Value Line, Zacks

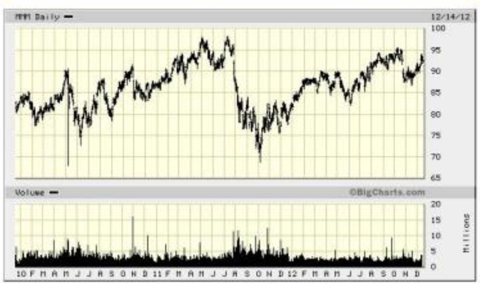
Value Line gave the shares great ratings in three of four of their key metrics. They rate only average in 'price growth persistence' because they were trading for north of 24x earnings a decade ago.

Company's Financial Strength	A++
Stock's Price Stability	95
Price Growth Persistence	50
Earnings Predictability	80

Source: Value Line Oct. 18, 2012 issue

Soft economic conditions have led to tempered estimates. Zacks now sees $6.32 for calendar 2012 and $6.84 for next year. **These estimates represent all-time record EPS.**

3M MMM $92.28 3-years (daily)



EPS 2010: $5.75 2011: $5.96 2012: $6.32 (EST) 2013: $6.84 (EST)

Sources: BigCharts, Value Line, Zacks

3M has a 10-year median P/E of 17.6x. Post-recession, it has averaged just a shade under 14.5x. A rebound to simply 14.5 times expectations for 2013 would support a price near $100. A return to MMM's long-term average yield of 2.36% would also indicate a $100 target based on the present 59-cent quarterly payout.

MMM typically increases its dividend early in each new year. A higher absolute payment could shift my one-year target zone to a higher level. Research firm Morningstar is of a similar mind. Morningstar calls present-day fair value as $100 and assigns MMM with a 4-star (of 5) Buy Rating.

MORNINGSTAR MMM $92.28 Dec. 14, 2012

3M Co MMM | ★★★★ Fair Value Estimate $100.00

Option savvy traders might want to consider buying 100 shares now while selling a January 2014 13-month call at a $95 strike and a January 2014 put with a $90 strike.

Note: This position is referred to as a "Buy-Write" – buying the stock, selling a call and selling a put. Overall, it's a bullish position, but the sold call will move in the opposite direction of the stock and the sold put. Both the stock and the call move together, but in this case, we would be long the stock and short the call (also known as a "covered call"). The sold put will move in the same direction as the stock – while the stock and the put move in opposite directions.

More at this link.

Two stocks in Paul Price's Virtual Value Portfolio - Interactive Brokerage Group (IBKR) and Dolby (DLB) – are going ex dividend for special payments this week on Wed. 12/19.

Note from Paul:

Online brokerage firm IBKR will go ex-dividend for a special $1.00 per share extra dividend on Wednesday, 12/19. Payment will come on 12/28 to beat the expected tax increases. To qualify for the dividend, shares of IBKR need to be purchased before Tuesday, 12/18, 4:00 pm est.

Dolby (DLB) also goes ex-dividend for a special $4 per share dividend on Wednesday 12/19. Payment will be on Dec. 27.

Position: Long IBKR and DLB shares.

Disclosure: *MarketShadow* writers may own stocks discusses in this section and may buy or sell these stocks at will, with no notice, in the future. Click on this link for the Market Shadow's Virtual Portfolio.

Biotech Corner

Monoclonal Antibodies (Part 2)

Courtesy of Pharmboy

In Part 1 of Monoclonal Antibody Companies, I highlighted a leader in the field, Seattle Genetics (SGEN). It's technology incorporates monoclonal antibodies (mAb), and also allows for having a drug 'tagged' on the mAb, so that when the mAb attaches to a cell, it is 'ingested' into the cell, and the drug is released. The antibody-drug combination is called an antibody-drug conjugate (ADCs). ADCs are "empowered" antibodies. They are designed to use the targeting ability of the antibody to precisely deliver the toxic drug where it's needed, increasing its effectiveness and decreasing side effects.

Think of the technology as a bunker buster bomb, that is guided by a laser, hits its target, penetrates, and then destroys all from within. Seattle Genetics has licensed its technology to several companies. Other companies are involved in this kind of research as well.

Antibodies are used by the immune system to clear pathogens from the body. The antibody protein is in the shape of a Y, where the trunk is the effector region (similar in most antibodies) and the ends of the Y are the variable regions (paratope) that bind the pathogen (antigen).

Antibodies are produced by B-cells and used by the immune system to identify and neutralize foreign material such as bacteria and viruses. There are several types of antibodies made for the defense of the body. (More here)

ImmunoGen, Inc. (IMGN, $12.92) was a pick several years ago at Phil's Stock World after the FDA declined to give it (and Roche) accelerated approval, even though its treatment for breast cancer worked (here). IMGN uses a similar technology to SGEN, coined Targeted Antibody Payload (TAP). TAP is simply a monoclonal antibody which carries a highly "toxic payload" of anti-cancer drugs to the cancer site. Using TAP allows toxic cancer drugs to be better tolerated by the patients because it minimizes the side effects of the drugs.

Trastuzumab-DM1, or T-DM1 for short, is for women with advanced HER2-positive breast cancer who have previously received multiple HER2-targeted medicines and chemotherapies, including Genentech's Herceptin. A mid-stage study of the drug showed that it shrank tumors in women with HER2-positive breast cancer, a form of the malignancy in which the protein, human epidermal growth factor receptor 2, promotes the growth of cancer cells. Unfortunately, this lead drugs is licensed to Roche, and IMGN's royalties are light at 5% (here).

IMGN has an exciting pipeline, including:

1. Lorvotuzumab mertansine (IMGN901) is a CD56-targeting TAP compound wholly owned by ImmunoGen. It is a potential new therapy for treating small-cell lung cancer (SCLC) and other cancers that express CD56. From IMGN's website: "SCLC is a highly aggressive cancer that almost universally expresses CD56 and has limited treatment options today. These factors, taken together with IMGN901 preclinical and clinical findings, led us to pursue SCLC as its lead indication. We are evaluating IMGN901 for first-line treatment of SCLC in our NORTH trial. This Phase II assessment evaluates IMGN901 used together with etoposide/carboplatin (E/C) – a standard care for this cancer – to determine if the addition of IMGN901 to E/C meaningfully improves duration of progression-free survival (PFS). Patients enrolled in the NORTH trial receive E/C either with IMGN901 or by itself." The dose of IMGN901 was established in a Phase I study.

"IMGN901 is being assessed for MM [multiple myeloma] used in combination with lenalidomide plus dexamethasone, a standard care for this cancer. Promising data were presented at ASCO in June 2011 from the dose-finding portion of this Phase I trial. We expect to report final data from this trial at a medical meeting in late 2012. Data were presented at ASH this past month (here), and the drug shows encouraging results."

2. IMGN529 is being investigated to treat B-cell malignancies such as non-Hodgkin's lymphoma and chronic lymphocytic leukemia. IMGN529 preclinical data have been reported at a number of major scientific conferences. This scientific poster includes data on the expression of IMGN529's target, CD37, on B-cell cancers, IMGN529's mechanisms of action, and its activity in preclinical models. This is early on, but CD37 is an interesting target for cancer. (More here)

IMGN has licensed its technology to Biogen Idec, Sanofi, Amgen and Roche. I think the stock can move into the $15-20 range in the next year or two and am going to add 100 shares to Pharmboy's Virtual Portfolio on Monday.

Disclosure: I do not own any shares of IMGN, but may purchase shares or options at any time.

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