The World's Worries Get the Market Brush-off

Investors shrug at accusations of Russian invasion of Ukraine. Wall Street's still a cheerleader. What McDonald's must do to make its shares tasty again.

By VITO J. RACANELLI
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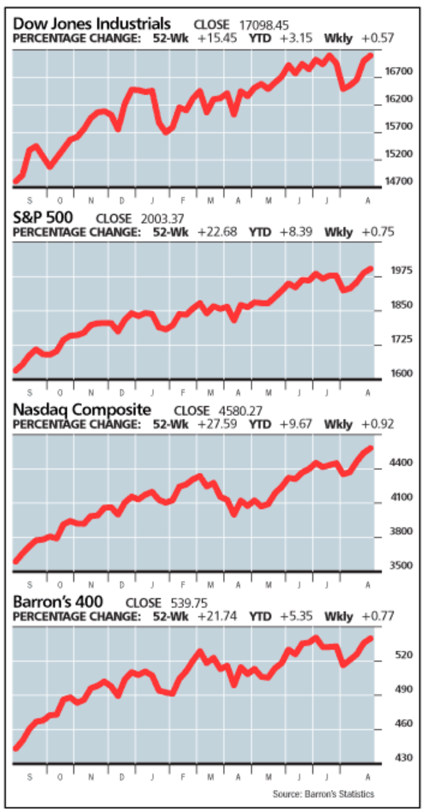
Vital Signs

"What, me worry?" In the face of escalating geopolitical tensions, the stock market offered the rallying cry made famous by Mad magazine's Alfred E. Neuman. Apart from a brief slip Thursday, after Ukraine accused Russia of invasion, the market was so unfazed that the Standard & Poor's 500 index finished the week at an all-time high.

Continued strong U.S. economic data, combined with the close of a better-than-expected second quarter earnings period, trumped the worries, even the threat of war. Trading, however, was light ahead of the Labor Day holiday Monday, and by Friday many market participants had slipped off to an early start of the weekend.



The market doesn't discount the same thing over and over again, even violence. From a purely investment perspective, trouble in the Middle East for U.S. markets is more important than in Ukraine because of its potential effect on oil markets and energy prices, says Joseph Amato, the chief investment officer of Neuberger Berman. Market action suggests investors are paying attention to the geopolitical tensions but not expecting an energy crisis, he adds.

The current level of tensions is relatively low for the market and "dwarfed" by the potential impact on stocks of actions by the Federal Reserve and the European Central Bank, he says. Last week, the Dow Jones Industrial Average rose 97 points, or 0.6%, to 17,098.45, and the S&P 500 climbed 15, or 0.75%, to a record 2003.37. It rose nearly 4% in August. The Nasdaq Composite index advanced

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about 42 points, or 0.9%, to 4580.27.

Second-quarter earnings and revenue-per-share gains of 11.7% and 6%, respectively, suggest that the corporate environment remains supportive, says Chris Gaffney, senior market strategist at EverBank. Low rates, good consumer confidence, and growing business confidence bode well. The wild cards are rates and those geopolitical tensions, "where the black swans sit," he adds.

Things might get bumpy by October, as the Fed winds down its U.S. Treasury bond buying, says Benjamin Halliburton, the chief investment officer at Tradition Capital Management. As that happens, investors will be on pins and needles, and volatility could increase.

Last week's economic data releases were robust. July pending home sales rose 3.3%, more than expected. The first revision of second-quarter U.S. real gross domestic product's annual growth rate was 4.2%, higher than expectations. And jobless claims continue to fall.

With Labor Day upon us, the market is about to enter what is historically its most treacherous month. According to Bespoke Investment Group, the S&P has averaged a decline of 1.1% in all Septembers going back to 1928, with gains in the month less than half the time. Perhaps this one will be less scary. In years when the market was up in the first eight months, as it is now by 8%, September averaged a 0.2% gain, with positive returns half the time.

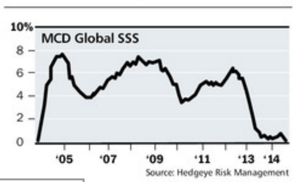
Time For McDonald's? Not Yet
When will Mickey D climb out of its funk?

This column has harped on the problems at McDonald's on several occasions in recent years, the latest in October. Call it tough love. The stock (ticker: MCD), which closed Friday at $93.72, has been in a rut for nearly three years, orbiting in a 10-point range around $95, despite a raging bull market. It has sharply underperformed the Dow, of which it is a component.

Since the end of 2011, shares of the world's largest fast-food operation are down 6.6%. It is the only Dow stock in the red in that period. From 2003 to 2011, it was the Dow's hottest performer, up more than 500%.

Too Much to Choose From?

McDonald's trailing 12-month same-store sales have plunged since April 2012, not long after the company complicated its menu through the introduction of beverages and new food items.



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The malaise reflects little or no revenue and profit growth since 2011, the last in a long series of double-digit percentage growth in annual earnings per share. Global same-store sales peaked at 5.6% in 2011, and have been sliding ever since—effectively flat after 2012 (see chart nearby).

Given management's second-quarter guidance, puny same-store sales will continue in the second half of 2014.

The operational weakness has led to substantial drops in consensus analyst annual earnings-per-share estimates. For 2014, it's now $5.55 versus $6.11 a year ago, and for 2015, $6.02 versus $6.72. The price/earnings ratio is now about 15.6 times, below the long-term median of 17.

What gives? Undoubtedly, slow global growth, particularly in Europe, a big market, and a rising minimum wage here have been a drag on the Oak Brook, Ill.–based firm, which has some 35,000 restaurants around the world,

Howard Penney, an analyst at Hedgeye Risk Management, an independent research firm that lists McDonald's as a short idea, says that it's no coincidence that 2011 represented the peak year of the rollout of new beverages, such as smoothies, and the McCafé line of products, such as espresso coffee. The beverages were part of a broader 50% increase in the number of menu items in that period, including food, he observes.

"That's increased the complexity of its business in the back of the house and decreased the throughput," Penney adds. In tangible terms, that means too many choices for customers, who wait longer for their orders.

There has been a change in the marketing message, too, with the company spending more on beverages—albeit a higher-margin business—and less on food, he says. Recent changes, such as fewer promotional offers and "high-density kitchen-prep tables," are a Band-Aid unlikely to accomplish the intended results, Penney says.

Instead, McDonald's should "reshape McCafé" to de-emphasize beverages and focus on food, where it has expertise, the analyst maintains.

McDonald's is a food, not a beverage, destination, he argues, but the company is attempting to be all things to all people. Until it addresses the McCafé complexity issues, fixing the core business will be difficult, he adds.

A McDonald's spokeswoman responded in an e-mail message that McCafé continues to resonate well with customers around the world and that after its launch, McCafé added at least $125,000 in sales per restaurant. It continues to contribute to McDonald's profitability, she continued.

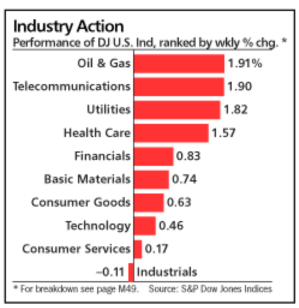
Granted, McDonald's stock is near a three-year low, the P/E multiple is relatively cheap, and there's a 3.5% dividend. Often, when we see a big Dow stock underperforming this badly, it attracts our interest. But it's not yet so far down that the only way is up, especially since continued EPS estimate downgrades are likely and will keep pressure on the stock. A company as big as McDonald's is no stranger to turnarounds, but much work is needed before there's evidence of improvement.

Short of an unlikely swift and big change, the only way this stock outperforms is if the market itself falls sharply and there's a wholesale investor move to defensive stocks. The answer to our initial question is: We don't know when Mickey D will climb out of its funk, but it likely won't be soon.

What Wall Street Hates

Wall Street analysts are widely followed by U.S. investors for their industry acumen and stock picking, and they are cited in these pages from time to time. Individually, some are good at what they do and some are not. Despite the good ones, collectively the analyst community provides the consensus thinking that savvy investors should be wary of and even play against when the sentiment is overwhelming.

Studies have shown that over long periods, it pays to buy stocks that are uniformly hated by Wall Street and avoid stocks that are most loved.



Bespoke Investment Group has done an interesting analysis of all current ratings for stocks in the S&P 500—12,052 viewpoints as of Aug. 26. Some 50% of the total are Buys; 44%, Holds; and 6%, Sells. This ratings spread is roughly in line with historical norms, according to Bespoke, confirming suspicions that Wall Street is often a cheer-leading section for stocks. Even after two bad bear markets in the past 15 years, Wall Street remains loath to say "Sell."

Looking at stocks with more than 10 analyst ratings, Bespoke found that the best-loved now is Delta Air Lines (DAL), where 100% of the ratings are Buys. A close second is American Tower (AMT), with 96% Buys.

With such a massively one-sided view of these two stocks, it would seem hard for things to get any better, ratings-wise. Business for Delta, which is doing well, might improve, but the ratings can't. But in cases like this, one question that investors should ask is: If everyone loves and owns a stock, who's left to buy it?

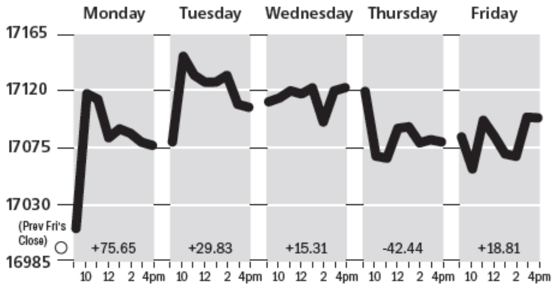
Conversely, if everyone hates a stock, who's left to sell it? Bespoke looked at stocks with the most Sell ratings. Some 41% of Diamond Offshore (DO) ratings and 35% of Transocean (RIG), both oil drillers, are Sells. That's no surprise, because the drilling group has been in the doghouse for a while. Clorox (CLX), Southern (SO), and Deere (DE) all have roughly one-third Sell ratings, as well.

Looking at stocks this way is more technical than fundamental. Yet, the analysts themselves are doing fundamental analysis, so it doesn't ignore the fundamentals and actually distills them, in a way. Betting against the analysts doesn't lend itself to picking single stocks. A portfolio method would be better, and there are numerous mutual funds and exchange-traded funds that are called "contrarian," though the basis of that stock-picking is typically very lowly valued stocks, based on metrics such as cash flow.

Probably, there would be overlap between the latter funds' holdings and those of a putative fund that picked stocks purely on the basis of analyst ratings, but we don't know of any. Maybe there's an opportunity there.

FIVE-DAY DOW COMPOSITE

Unbowed: The Dow rose 0.6% last week, finishing close to its all-time high, as investors ignored rising geopolitical tensions. UnitedHealth rose 4%, but Visa fell 2%.



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