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Stocks --- The Trader: Neutral Market Stays Resilient

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Being stuck in neutral raises the risk of a vehicle rolling down harrowing declines. But this also allows it to be pushed uphill, even if it takes some exertion.

For all of last week's unwelcome drama created by the violence and hardship in London early Thursday, the U.S. stock market's response, more than anything, spotlighted its continued neutral state.

With European markets selling off severely as dawn reached New York, the Standard & Poor's 500 index futures were sitting with a nearly 3% loss, following a weak and sloppy market close Wednesday. Yet as the morning wore on, upper lips stiffened as no further attacks occurred and the incident appeared limited to a wrenching series of explosions in central London, not a global assault.

Art Cashin, the head of NYSE floor operations at UBS, notes that the passing of the East Coast rush hour without interruption emboldened buyers, and stocks marched steadily higher throughout the day.

Nearly every Wall Street trading desk heard strategists over the squawk boxes invoking the analogy of the earlier Madrid attacks, when a sudden drop in prices shook out nervous sellers, but proved only a fleeting setback. Bids awaited the open in the U.S. and the damage never even reached 1% in regular trading.

The marquee indexes posted small gains on the day, with the S&P 500 traversing more than 3% from the pre-market low to its close. The gains followed through strongly into Friday, as the middling employment report presented no obstacle to buyers who were encouraged by Thursday's "can't keep them down" act.

The indexes put in a slim weekly advance, with the Dow Jones Industrials adding 145.7 points, or 1.4%, to 10,449.14. The S&P 500 once again crossed the 1200 level, gaining 17.42 points, or 1.5%, to 1211.86. The Nasdaq rose 55.51, or 2.7%, to 2112.88.

Resilience was the word of the week for those trying to describe the action. Certainly, it's hard not to be impressed with the recovery, even if it represented the passing of a limited, short-term test. The leadership sectors -- brokerage stocks, biotechs and homebuilders, to name a few -- were the kinds that benefit from building investor confidence and rising risk appetites.

There was a contrasting stream of commentary, of course, that attributed the upside in the face of terror to a dangerous habit among investors of overlooking major risks -- the financial equivalent of whistling past the graveyard. It's certainly arguable that the more investors become conditioned to meeting exogenous threats with buy orders, the more vulnerable the market will become to a shock some dark day down the road.

But the final arbiter of the market's health is the tape itself, and the week just past leaves the diagnosis the same as before the attacks. The uptrend from the springtime low is intact, but the headline indexes are bumping up against levels that have stymied them in the recent past.

If, as might be expected, the self-congratulation by investors for keeping cool last week leads to yet another short-term extreme in bullish sentiment, this could dampen any effort to mount a new 2005 high in the large-cap indexes.

Note the qualifier "large-cap indexes," because measures of smaller stocks or indexes that weight stocks equally are, in fact, not laboring below stubborn old levels. The S&P Small-Cap 600, the Russell 2000 and the S&P 500 Equal-Weighted index (which trades as an exchange-listed fund under the symbol RSP) all hit new all-time highs last week.

This helps explain how the median stock in the market is trading just 6% below what Ned Davis Research considers evidence of extreme optimism, based on data dating to 1972.

It's as easy to argue that this largely obscured new bull-market high in the average stock means the market on the whole is deceptively strong, or that the rally of two-plus years is entering a final stage. Verdict pending on this debate.

The backdrop: Economic data remains mixed but palatable on the whole. Investors seem still to be a bit too hopeful of having the Fed quit boosting interest rates, though this mindset probably won't be a hindrance for the immediate future.

The flat performance of the indexes this year perhaps shows the market to be digesting a deceleration of growth, and the lumpiness of corporate profit increases, in which energy and materials companies are responsible for much of the gains. Maybe once the initial shudder of the London news dissipated, stock watchers welcomed the ability to turn to the workaday stuff of economic data and earnings reports. Alcoa (ticker: AA) shares, laggards along with other materials stocks, caught a nice breeze Friday when the company launched earnings season with a well-received report.

There will be plenty more earnings reports to absorb in the coming weeks, of course. Count on them conveniently getting the credit if the market manages to kick into gear, or the blame if it remains stuck in neutral.

Calling It

The relative quietude of the major indexes' longstanding and narrow trading range engenders a sense of foreboding in some market forecasters, and in others the confidence of riches to come.

The temptation to make aggressive calls, bearish or bullish, seems acute at the moment. A number of observers, especially some chart-focused analysts, have confidently proclaimed the early March high of 1229 on the S&P 500 as the high for the current bull market.

On the upbeat side, a distinct group of strategists is pointing to what it views as signals of excessive risk aversion (high cash balances in brokerage accounts, stagnant price/earnings multiples, persistently low bond yields and such) as proof that the smart money should be buying.

To this latter crowd, the salient analogy is 1995, when low-volatility markets at the end of a Fed-tightening cycle gave way to a series of up-20% years in the indexes. (The raw circumstantial evidence is there, but please note: The '90s were likely a once-in-a-generation bull market, not a post-bubble phase, and the Fed reversed and cut rates in the middle of that year.)

One or the other of these turning-point scenarios could prove to be right. It's never possible to say for sure what the market is fixing to do.

But it's at least as plausible that the environment, already frustrating for most investors and traders, could continue to confound both the high-conviction bulls and bears for a while longer. A full summer of false starts, halting moves, evanescent rallies, one-day selloffs, mere noise disguised as a crucial clue about the future -- could this be the Street's immediate fate?

If so, it would fit the broader pattern. Employment numbers have been alternating one reasonably strong month with one dud. Retail sales have been similarly fickle, though with a continued upward cast. Neither the economic doomsday crowd nor the cheerleader factions have found consistent affirmation in the data flow.

Ned Davis has been stressing to clients that the moment when the Fed tightens for the final time has not, historically, been a profitable moment to buy. Partly this is because it often has preceded recessions.

But taking cues from the market's bearing and trajectory, Davis sees no immediate reason to sound loud alarms either. Two-sided caution is the result.

He says, "Market evidence remains mixed, and thus the market will likely continue in a broad trading range. A neutral outlook is always wrong short-term because the market is always moving up or down near-term." Yet 15 months ago, he notes, he said the market's "traffic light has turned from green to yellow, and in my own hedge- fund trading account we are moving toward as many shorts as longs."

That was on April 14, 2004, with the Dow at 10,381 -- within 1% of today's level.

Woody Dorsey, a market-timing advisor to hedge funds and others through his **Market Semiotics** research firm, has kept a step ahead of the tape with his focus on investor sentiment, mass psychology and technical analysis.

Lately he has pressed the theme that the vast majority of the bull market's upside is probably in the books, but a baffling sideways period could feint and parry with both bulls and bears for some time to come.

Dorsey, a coiner of pithy phrases to describe his market views, has been calling for a summer "slogathon," in which a "modest upside summer bias translates into choppy distribution rather than substantive upside."

To his credit, as the market opened Thursday he told clients "this is not a selling opportunity. In fact, shorts should be looking to cover on this."

The upshot, in his eyes, is likely a tantalizing but ultimately range-bound period into August, where leaving the markets for the beach probably won't be penalized, which will precede a stiff test in the fall.

Surf Boxes

It was only 13 years ago that Bruce Springsteen lamented in song about having "57 channels and nothin' on." How quaint.

Thanks to advances in digital cable systems, the typical American home can, or will soon, enjoy hundreds of channels of nothing to choose from, often with the ability to buy movies on demand and to record shows for future viewing.

Scientific-Atlanta (SFA) is one of the chief producers of the cable boxes and other gear that has so broadened the channel-surfing shoreline. Demand growth for the fancier digital boxes looks strong for the next couple of years as the country (and, indeed, the world) moves closer to its destiny of unbounded entertainment possibilities for the couch-bound. For instance, Scientific-Atlanta's sales of high-definition capable boxes in the March quarter rose 120% from a year earlier.

The market for set-top boxes is essentially split between Scientific-Atlanta and Motorola (MOT). The former, clearly, is the purest play on the advances in digital cable, with another growth avenue in telecom as the likes of SBC Communications (SBC) and Verizon (VZ) move to fashion TV service over their lines.

Scientific-Atlanta boasts a financially potent balance sheet and impressive cash-generating power. With the shares recently near 37, the company has $9.50 a share in cash and essentially no debt. With a market value of $5.6 billion, the cash holdings bring the enterprise value (equity value minus net cash) to $4.1 billion.

Earnings for the fiscal year ended June 30 should come in around $1.55 a share, with projections for the just-begun fiscal year around $1.75. In fiscal 2007, net should exceed $2.

Free cash flow in the current year is pegged to come in around $1.60 a share, according to CIBC World Markets analyst Lawrence Harris, computing to a free-cash-flow yield of 4.3%.

Excluding the cash on hand (and the interest earnings from that cash), Scientific-Atlanta shares are valued at less than 16 times the coming year's expected profits. The company is an aggressive repurchaser of its shares, as well.

J.P. Morgan analyst Ehud Gelblum, who gave the shares a sharp lift Friday with an upgrade, notes the company's heavy order backlog and believes the restructuring of Adelphia (being bought by Time Warner and Comcast) could drive another wave of digital-box upgrades.

All this leads some partisans of the stock to project the stock's fair value well above $40 by virtue of the fundamental outlook.

But there's also percolating speculation that Scientific-Atlanta's management may not wait for the market to close any perceived value gap. Rumors have been circulating that the company is being shopped around for a sale, with unconfirmed talk that an investment bank has been hired for the task.

This is not the first time Scientific-Atlanta has been the subject of such talk, it should be said. But market players appear more receptive to the idea lately. The stock is up 30% in the past three months, in a flat market.

One indication that some folks are betting on a possible deal is the bulge in outstanding August call options on the stock at the 35 strike, a concentration of such bets that's far in excess of normal levels, which were accumulated as the stock was more than 10% below that level.

The takeover talk is buttressed by the fact that James McDonald, CEO since 1993, is 65 years old and no clear successor is in place. Possible strategic buyers, according to traders, might include Asian powerhouses Sony, Samsung or LG.

A Scientific-Atlanta spokeswoman had no comment.

Of course, no deal might happen. And some observers are concerned about business risks, such as potential market-share losses in the nascent telecom TV channel. But such a financially strong company in a briskly growing business, with a modestly valued stock would seem to offer some margin for error to investors at today's prices.