Fed Hints at Rising Rates, but Stocks Rally

By VITO J. RACANELLI | MORE ARTICLES BY AUTHOR

A bump down right after the Yellen speech, then resilience. Plus, why Target looks like a bargain. Investment value in tweets? New day could dawn at CommonWealth.

One bad day of Fed-induced fretting about interest rates didn’t spoil the whole week, and by Friday the broad market had closed up 1.4%. Fading from view—at least for now—is the ratcheting up of sanctions and rancor between the West and Russia over the illegal absorption of Crimea.

Comments from the Federal Open Market Committee (FOMC) and chair Janet Yellen on Wednesday suggested the Federal Reserve might raise its funds rate earlier than expected and shook up both stocks and bonds temporarily.

Despite that, on the week the Dow Jones Industrial Average still rose 237 points or 1.5% to 16,302.77. The Standard & Poor’s 500 index rose 25 points, or 1.4%, to 1866.52. On Friday the S&P reached a new intraday high of 1883.97 before fading. The Nasdaq Composite index added 31 points, or 0.7%, to 4276.79.

In a policy statement Wednesday, the FOMC hiked guidance for the federal funds rate to 1% at the end of 2015 and 2.25% at 2016’s end, compared to the previous 0.75% to 1.75%, respectively; it’s currently 0-0.25%. The Fed repeated that the funds rate will remain near zero for a “considerable time” after its bond-buying program ends. However, at the press conference afterwards, Yellen was asked to clarify the timing and said it “probably means something on the order of around six months.”
She shocked the market by putting a number on it—six months, notes Frederic Dickson, chief investment strategist at D.A. Davidson. Investors are still mulling whether that was just a rookie mistake or perhaps an inadvertent disclosure of FOMC thinking. Investors know rates are going up, and probably in 2015, yet the subject will likely remain a trip wire for market volatility in coming months.

The market's new intraday high might be bracing but the makeup of the rally is worth exploring. For example, Ralph Fogel, head of investments at Fogel Neale, points out that fewer and fewer individual new stock highs are being seen even as the broad market rallies. Last May, for example, there were 762 new stock highs. That's down to 234 Thursday. The base of the market's high is narrowing, composed of fewer and bigger-capitalization stocks. It doesn't mean the bull market is over, but it's not a particularly good sign.

The road to a more normalized interest rate environment probably began in earnest last week. Get used to it.

**THE NEWS THAT HAS DOMINATED** the headlines recently for giant retailer **Target** (ticker: TGT) has been the data breach late last year, when Target customer payment-card and other information was stolen. So far, Target has incurred $17 million of net expense for the incident, but it hasn't been able to estimate future liabilities.

The damage, however, was more to its credibility—and its stock price, as $8 billion was carved out of Target's market value, now $38 billion. At Friday's close of $59.45, the shares are down nearly 20% from their $73 high, hit in 2013. The decline has taken the shares back to levels first reached in 2010, and the market is up more than 50% since then.

In a market where few stocks of strong, reliable dividend-paying firms are cheap, Target looks attractive. Over a century old, it has nearly 2,000 stores across North America, more than 90% of them in the U.S. It remains a good operator with a recognized brand, despite what are likely to be short-term headwinds.

The Minneapolis-based retailer sells everyday essentials like linens and baby powder, as well as fashionable merchandise at a discount. Customers are an economic step or two up from those of **Wal-Mart Stores** (WMT), and they are often looking for "panache at a discount."

The other problem is a sales slowdown, though some of that is residue of the data breach, which happened during the Christmas selling season. Target also opened stores in Canada last year—it has 124 there now—and they aren't performing well.

Nevertheless, the focus on the data breach is obscuring Target's attractions. That's an opportunity for patient investors with a long-term view. "The data breach is a discrete, fixable problem," says Bernie McGinn, president of McGinn Investments. He has recently been adding Target shares to his longstanding position. The brand is strong, the company well run, and ultimately Target will turn things around so customers who were driven away by the breach will return, he predicts.
More concerning might be the underperforming Canadian outlets. Stores in the Great White North have half the gross margins of U.S. outlets, and Target's Canadian segment had an operating loss of about $1 billion last year. That hurt. In the fiscal year ended on Feb. 1, 2014, Target reported sales flat, at $72 billion, and earnings per share of $3.07, compared with $4.52 the previous year. The Canadian segment lowered the most recent year's EPS by $1.13.

But even here, things are not as gloomy as the 20% plunge in the stock price might indicate. "Canadians might not be as 'Target-happy' as Americans—yet. These are new stores, and it's too soon to tell," says McGinn.

Target seems undeterred, giving profit guidance of $3.85 to $4.15 a share this year. Based on the current stock price, that would produce a price/earnings ratio of about 15, which is below its long-term 16.5 median P/E. The retailer has sported an average 5% to 6% revenue and double-digit percentage EPS gains. The shares also sell at a discount to the S&P 500, of which Target is a component. Typically, they have fetched a premium.

Will the data breach outweigh customers desire for products, especially stylish ones, at cheaper prices? Says McGinn: "I don't think it will, and two years from now, no one will remember" the problem. It's true that the final cost of the breach is not yet known, but it's likely to be a one-time hit. And, as noted, $8 billion already has been removed from Target's market cap.

McGinn thinks the stock could climb back to its old high over the next two years. Then there's the 2.9% dividend yield. Target's problems won't be solved overnight, but the potential return and the shares' generally low volatility will likely be worth the wait.

THE STOCK VALUATION of Twitter (TWTR) is the subject of hot debate, but what about the social-media company's value as an investment tool? Excuse me? Millions of 140-character tweets are emitted per day, but can those about stocks—some knowledgeable and some not—give investors any useful information?

A recent report from Markit, a global financial-information service firm, says that such tweets provide the basis of important short-term sentiment indicators. When those indicators are properly collected, scrubbed, and analyzed, they can help build a trading portfolio that beats the market. "There is information on Twitter that has predictive power in the stock market," asserts Chris Hammond, director of the Markit signals-research team. The challenge is to sort the noise from the informative content and then create an investment strategy that marshals the useful signals.

The stock-sentiment signals from tweets have a short duration—up to five days—but they "are powerful," he says, if interpreted correctly. Markit takes tweet data collected by Social Market Analytics, which filters them. SMA analyzes the data using language-processing software and other tools, to find content with trading relevance. A tweet about an Apple (AAPL) product isn't as useful as one about Apple's stock, and the two are scored differently.
Other factors include the total volume of tweets about a stock and even the accuracy or source of the tweet. A tweet from Carl Icahn, for example, would have more power to move a stock on a short-term basis than the typical tweet. Turns out there are on average about 7,800 relevant stock-market tweets per day.

These are scored for market-sentiment content and aggregated for each stock to produce sentiment measures. Hammond says indicators are detecting something new, and he has found little or no correlation with more traditional sentiment gauges, such as analysts' earnings revisions, among others.

Markit claims that since Nov. 30, 2011, its buy portfolio of tweeted-about stocks has returned 76%. Markit compares that with the 20% over the same period for the SPDR S&P 500 Trust exchange-traded fund (SPY). Because this is a daily trading strategy, the churn rate is over 90%. Both the Markit buy portfolio and the SPDR ETF were bought at the open and sold at the close each day. No positions are held overnight.

The report is based on back-tested results, and the trades have been theoretical. Many investors will probably want to see ongoing live results before being convinced. Until there's an ETF using this strategy—Markit is working on one—we'll reiterate that it's not an investment method for individuals, but it could be of interest to institutional investors.

ON TUESDAY, the Commonwealth (CWH) saga took a giant step toward what would be one of the more unusual denouements in real-estate investment trust history. A group of activists, led by Corvex Management and Related Fund Management, which together own 9.6% of Commonwealth stock, received consents from holders of more than 81% of the shares backing their proposal to remove Commonwealth's entire board of trustees. The company said it will inspect the consent proxy votes and declare the results by Tuesday.

Regular readers might recall a Barron's story last year ("Whose Commonwealth is It Anyway?" April 22) outlining activists' accusations of poor governance and conflicts of interest at the CWH board and management led by Barry and Adam Portnoy.

We noted that if the activists were successful, the stock, then $22, could move toward $30. On Friday, it closed near $27, for a market value of $3.2 billion. Commonwealth, whose 125 properties are mainly in second- and third-tier cities, has a book value of $4.6 billion and debt of $3 billion.

Jim Sullivan, an analyst with REIT research and analytics firm Green Street Advisors, called Commonwealth "uninvestible" in our story last year, due to the conflicts, among other things. If the activists are successful, he says now, Commonwealth would be on its way to "investible" status. A "cursory" Green Street estimate is that the shares could be worth $30.

Assuming that Commonwealth and the Portnoys accept the vote—not a given—the shares could eventually trade higher than that if new management undoes two decades of conflicts.
FIVE-DAY DOW COMPOSITE

Crimea Relief: The Dow jumped 1.5% last week as worries faded of a serious confrontation over Russia’s annexation of Crimea. UnitedHealth rose 7.5% and Nike fell 4%.

<table>
<thead>
<tr>
<th></th>
<th>Monday</th>
<th>Tuesday</th>
<th>Wednesday</th>
<th>Thursday</th>
<th>Friday</th>
</tr>
</thead>
<tbody>
<tr>
<td>Close</td>
<td>16030</td>
<td>16240</td>
<td>16135</td>
<td>16345</td>
<td>16450</td>
</tr>
<tr>
<td>Prev</td>
<td>-181.55</td>
<td>+88.97</td>
<td>-114.02</td>
<td>+108.88</td>
<td>-28.28</td>
</tr>
</tbody>
</table>

E-mail: vito.racanelli@barrons.com