‘Buy’ Signals Flashing With Plunge in Confidence: John Dorfman

Commentary by John Dorfman

Aug. 2 (Bloomberg) -- Consumer confidence last week hit its lowest level in five months, the Conference Board reported in its monthly sentiment survey. The **confidence index** fell to about 50, far below its 20-year average of about 94.

Many observers are taking the news hard. “Faith in the economic recovery is failing,” said Guy LeBas, chief fixed- income strategist at Janney Montgomery Scott LLC in Philadelphia.

For investors in the stock market, though, the bad consumer-confidence number could actually turn out to be good news.

Ned Davis Research Inc. in Venice, Florida, studied returns for the **Dow Jones Industrial Average** when confidence as measured by the Conference Board survey is high, medium and low.

When it is high (above 113) the Dow gained an average of only 0.2 percent over the next 12 months. When confidence is moderate (between 66 and 113) the index gained 5.9 percent.

The biggest gains came when confidence was low (66 or less). Then the Dow plowed ahead by an average of 13.1 percent.

Why is consumer confidence a contrary indicator for stocks? When confidence is low, many people have withdrawn from the stock market, whether because of fright, disgust or simple lack of funds to invest. Lots of cash is on the sidelines, and that cash is potential fuel for a rally.

When confidence is high, many **investors** have already committed much of their capital to stocks, and there is little left to fuel the fire.

Sudden Drops

Historically, stocks have also performed quite well following sudden drops in confidence. Joseph F. Kalish and Veneta Dimitrova, analysts at Ned Davis, studied 14 cases in the past 31 years in which the Conference Board number dropped at least 9.8 points in a month, a trigger that was reached with February’s 10.1-**point** decline.

Twelve months after such an event, they found, the Standard & Poor’s 500 Index had gained an average of 8.7 percent, excluding dividends. There were gains in 11 of the 14 cases.

A look at the historic extremes of the Conference Board’s measure may also be instructive. The highest reading in the past 20 years was in May 2000, about two months after the Internet- stock bubble started to deflate. Since then, the S&P 500 has yielded a return of negative 12 percent, including dividends.

Confidence Reading

The lowest confidence reading in the past two decades was about 25, in February 2009. That was just a few days before U.S. stocks began a major rally of about 50 percent in the subsequent six months.

If the next 12 months bring decent gains to investors, lots of folks will be surprised -- but that’s normal. If consumers see unemployment coming down and wages rising, greed will gradually replace fear.

Disclosure note: I have no long or short positions in the stocks discussed in this week’s column, personally or for clients.

(**John Dorfman**, chairman of Thunderstorm Capital in Boston, is a columnist for Bloomberg News. The opinions expressed are his own. His firm or clients may own or trade securities discussed in this column.)

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Last Updated: August 1, 2010 21:00 EDT