

Bianco Research L.L.C.

An Arbor Research & Trading Affiliated Company

Independent · Objective · Original

Volume 16, No. 10

1731 North Marcey, Chicago IL 60614

www.biancoresearch.com

Commentary

Market Opinions and Topics of Interest

By Howard L. Simons (847) 304-1511

March 8, 2005

Crude Oil's Selective Impact On Stock Groups

The surge in crude oil prices back toward record levels in front-month futures – **and to new record levels in the deferred contracts** – may have seemed like a foregone conclusion. Nothing in markets is inevitable, and despite the consistently bullish outlook we have taken toward crude oil, most recently in a February [Commentary](#), nothing is certain, either.

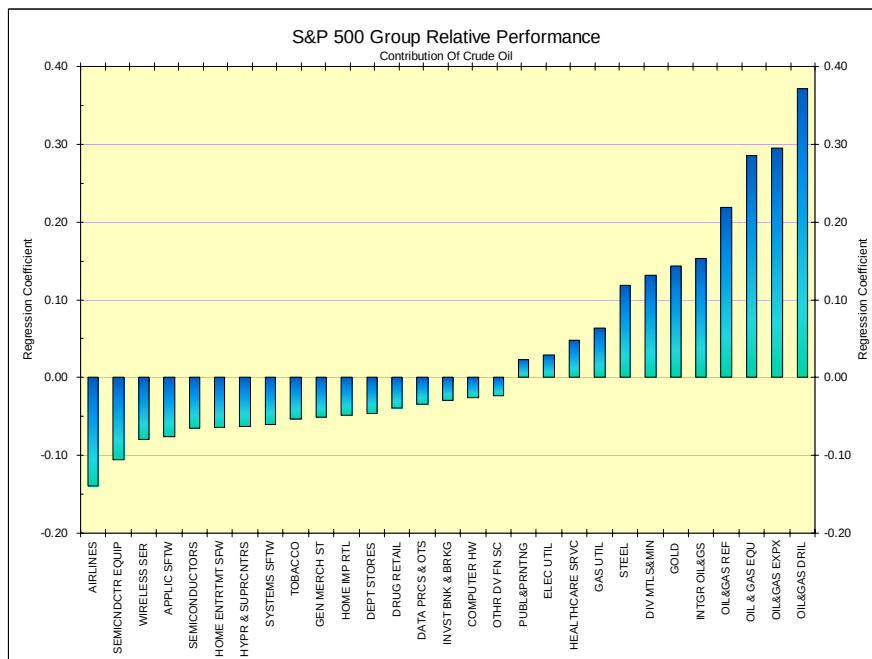
The same principle applies to the effects of a powerful and primary factor in financial markets such as crude oil. Prior to the experience of 2004, it was a foregone conclusion higher crude oil prices would damage the economy and thus the stock market. Conventional wisdom also held higher energy prices to be inflationary and therefore a negative for the bond market.

Conventions are not a good place to acquire wisdom. While the stock market rally of 2004 was compressed into a short period after crude oil's peak, the bond market rally between May and

October 2004 coincided with the ascent of crude oil to previously unthinkable levels. The intellectual reconciliation of these dual rallies was difficult even for those who long acknowledged the tax-like effect of crude oil and the dissociation between higher energy prices and monetary policy-induced inflationary pressures.

What is the current impact of higher crude oil prices on the stock market on an industry group-by-group basis? To answer that question in a straightforward and quantitative fashion, let's turn to an analytic tool introduced in a February [Special Report](#) on macroeconomic factors influencing stock group performance.

The chart below depicts the statistically significant betas, or relative volatility, of group performance relative to the S&P 500 against crude oil prices. Positive-beta groups can be expected to outperform in an oil-price rally; negative beta groups can be expected to under-perform in an oil-price rally.



Disparate Impact

Unsurprisingly, energy-related groups benefit the most from higher crude oil prices. The presence of Gold and Diversified Mining among the groups with positive betas is a tribute to how strong these two sectors have been on the backs of their own commodity rallies. The same can be said for Steel.

Groups whose performance relative to the S&P 500 have negative betas to crude oil prices include the woebegone Airlines, Semiconductors, Wireless Services, a number of software groups and retailers of various stripes.

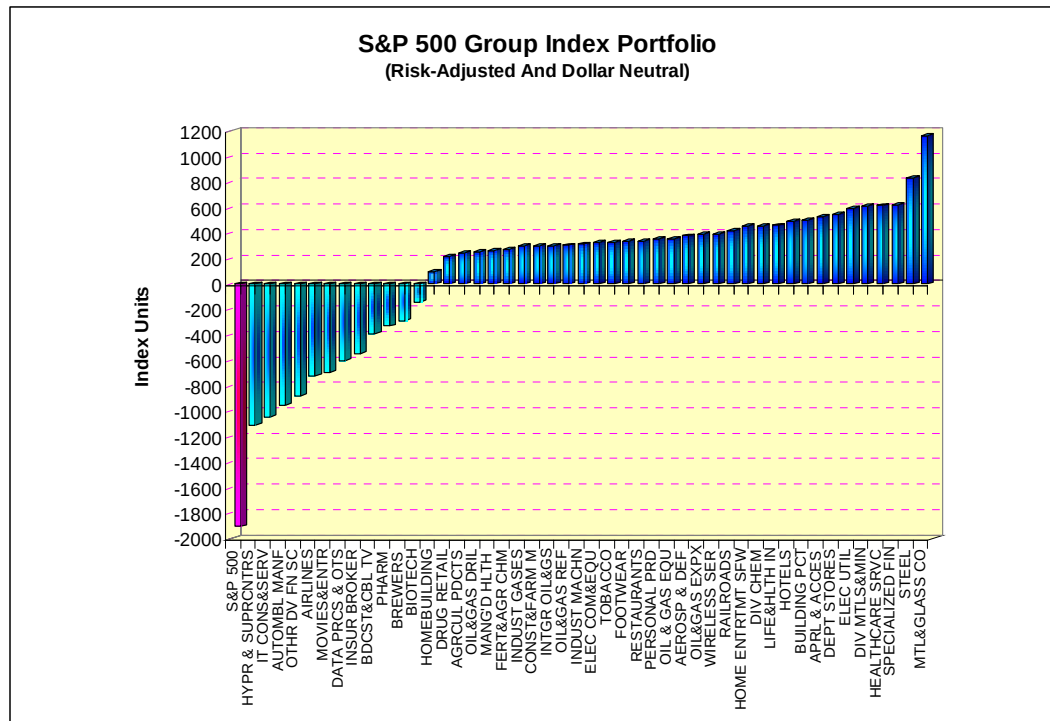
Equally interesting are the groups not included in this picture: Nowhere to be found are the Financials, Pharmaceuticals, Consumer Staples or other groups so important to both the overall health of the economy and the market. **What is missing often is of greater importance than what is present.** This is of particular importance when discussing a factor, crude oil, many of whose impacts are obvious.

Making The Alpha Bet

If we move away from the groups' betas to their alphas, or expected over- or underperformance relative to the market, we get a picture of which groups contribute most to manager performance. These alphas exist independently of crude oil prices and are simply the long-term basis point measure by which given groups out- or underperform.

The chart below depicts which groups have had a statistically significant alpha to the S&P 500. The alphas of these groups are combined in such a way as to construct a market-neutral and dollar-neutral portfolio. A "plug" position in the S&P 500 itself (red column) is added to achieve the requisite dollar neutrality.

A table of the chart data is appended at the end of the text.

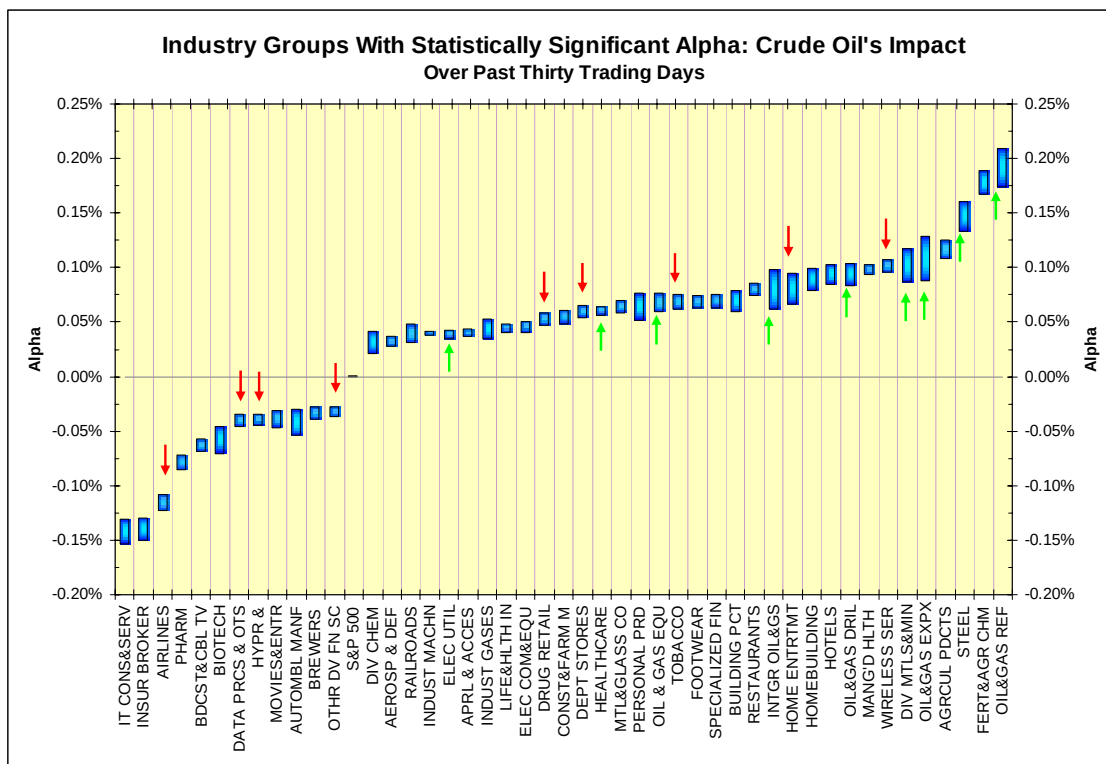


Factor Contribution To Alpha

Now let's combine the two analytic segments to depict which of these groups' alpha is affected in a statistically significant way by the contribution of crude oil prices. The chart on the following page depicts each one of the groups' alpha not as a last snapshot in time, but rather as a high-low range over the past thirty trading days. **The height of each**

blue bar represents this range; we can state that the greater this range, the more interesting that group should be to a momentum-type of trader.

A set of arrows is imposed on the chart. Downward-pointing red arrows denote a negative beta for that group against crude oil prices. Upward-pointing green arrows denote a positive beta for that group against rising crude oil prices.



Conclusion

Several groups stand out in this picture as demanding special attention. Those groups with positive alpha and a negative beta to crude oil (blue bars above the 0% line with downward-pointing red arrows) should be expected to underperform should crude oil prices continue to rise. These groups include Drug Retailers, Department Stores, Tobacco, Home Entertainment Software and Wireless Services. **We would regard this as an opportune time to reduce exposure to these groups.**

There are no recent underperformers with positive betas to crude oil (blue bars below 0% line with upward-pointing green arrows). The only sectors with such positive betas to crude oil with upward-pointing green arrows all have outperformed recently.

We regard this factor-based analysis of relative performance as a powerful tool, one that can be brought to bear not only on domestic large-capitalization equities but on all classes of fixed income and other types of equities as well.

Technical Data Bank: SPX Group Alpha Positions

S&P Group Index	Trade Signal	Index Units (x \$100)
S&P 500 (SPX)	Short	1905
HYPR & SUPRCNTRS (S5HYPC)	Short	1107
IT CONS&SERV (S5ITCS)	Short	1047
AUTOMBL MANF (S5AUTM)	Short	949
OTHR DV FN SC (S5ODVF)	Short	881
AIRLINES (S5AIRL)	Short	720
MOVIES&ENTR (S5MOVI)	Short	694
DATA PRCS & OTS (S5DPOS)	Short	604
INSUR BROKER (S5INSB)	Short	547
BDCST&CBL TV (S5BRDC)	Short	389
PHARM (S5PHAR)	Short	332
BREWERS (S5BREW)	Short	293
BIOTECH (S5BIOT)	Short	140
HOMEBUILDING (S5HOME)	Long	100
DRUG RETAIL (S5DRUG)	Long	215
AGRCUL PDCTS (S5AGRI)	Long	245
OIL&GAS DRIL (S5OILD)	Long	252
MANG'D HLTH (S5MANH)	Long	261
FERT&AGR CHM (S5FERT)	Long	269
INDUST GASES (S5INDG)	Long	300
CONST&FARM M (S5CSTF)	Long	301
INTGR OIL&GS (S5OIL)	Long	302
OIL&GAS REF (S5OILR)	Long	304
INDUST MACHN (S5INDM)	Long	313
ELEC COM&EQU (S5ELCO)	Long	328
TOBACCO (S5TOBA)	Long	330
FOOTWEAR (S5FOOT)	Long	335
RESTAURANTS (S5REST)	Long	335
PERSONAL PRD (S5PERS)	Long	353
OIL & GAS EQU (S5OILE)	Long	355
AEROSP & DEF (S5AERO)	Long	377
OIL&GAS EXPX (S5OILP)	Long	391
WIRELESS SER (S5WIRE)	Long	395
RAILROADS (S5RAIL)	Long	421
HOME ENTRTMT SFW (S5HMEN)	Long	455
DIV CHEM (S5DIVC)	Long	459
LIFE&HLTH IN (S5LIFE)	Long	461
HOTELS (S5HOTL)	Long	493
BUILDING PCT (S5BUIL)	Long	500
APRL & ACCES (S5APAC)	Long	531
DEPT STORES (S5DEPT)	Long	549
ELEC UTIL (S5ELUT)	Long	597
DIV MTL&MIN (S5DIVM)	Long	611
HEALTHCARE SRVC (S5HCSV)	Long	618
SPECIALIZED FIN (S5SPFN)	Long	621
STEEL (S5STEL)	Long	835
MTL&GLASS CO (S5METG)	Long	1166

Bianco Research L.L.C.

1731 North Marcey, Suite 510
Chicago IL 60614

Phone: (847) 304-1511 Fax (847) 304-1749

e-mail: research@biancoresearch.com

<http://www.biancoresearch.com>

For more information about the contents/ opinions contained in these reports:

President (847) 304-1511

James A. Bianco jbianco@biancoresearch.com

Strategists/Analysts (847) 304-1511

Howard L. Simons hsimons@biancoresearch.com

Greg Blaha gblaha@biancoresearch.com

Neil Bouhan nbouhan@biancoresearch.com

For subscription/service Information:

Arbor Research & Trading, Inc.

Director of Sales & Marketing (800) 876-1825

Fritz Handler fritz.handler@arborresearch.com

Patrick Lovett pat.lovett@arborresearch.com

Peter Forbes peter.forbes@arborresearch.com

Arbor Research & Trading, Inc.

1000 Hart Road, Suite 260

Barrington IL 60010

Phone (847) 304-1560 Fax (847) 304-1595

e-mail inforequest@arborresearch.com

<http://www.arborresearch.com>

For more information about Arbor Research & Trading and its services:

Director of Fixed-Income Sales (800) 876-1825

Daniel Lustig dan.lustig@arborresearch.com

Director of International Sales (847) 304-1560

James L. Perry james.perry@arborresearch.com

Arbor Research & Trading (UK) LTD

75 Cannon Street London England EC4N 5BN

Phone 44-207-556-7309 Fax 44-207-896-1887

For more information:

Director of Arbor (UK) 44-207-556-7309

Neil Tritton neil.tritton@arborresearch.com

Ben Gibson ben.gibson@arborresearch.com