New Constructs' feature is below.

THE TRADER

Stocks Slip on Euro Bank Jitters, Profit-Taking

Plus fresh look-sees on Boeing, Hawaiian Electric Industries, and Lumber Liquidators.

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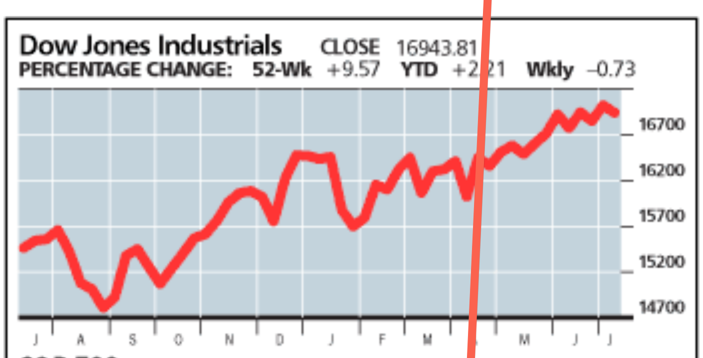
Vital Signs

Stocks backtracked almost 1% last week in quiet trading, mainly on profit-taking and short-lived jitters caused by reports that a relatively small European banking firm missed debt payments. For a few moments last Thursday, it looked like a Greek banking crisis redux.

Riskier small caps took the brunt of the beatdown, suggesting the return of the "risk off" trade. But the drop likely had more to do with a minor reversal—so far—of end-of-second-quarter capital flows into small-cap stocks, and profit-taking from record highs reached the previous week. Nervousness about the European banking sector reemerged briefly Thursday morning after news reports said Portuguese conglomerate Espírito Santo International—the largest shareholder in the parent of Portugal's largest bank, Banco Espírito Santo (ticker: BKESY)—missed a debt payment. Stocks pared the losses Friday.



With the 64-month-old bull market not far from all-time highs, investors will be better served by focusing on U.S. shores in coming weeks as second-quarter earnings tumble out in bunches from the likes of JPMorgan Chase (JPM), Intel (INTC), Johnson & Johnson (JNJ), Some investors probably have taken profits after that tremendous 2013 run, says Doyle. Despite the stock's drop, he remains a fan because margins are climbing and airlines are doing well.

Boeing's long-term attractions remain. Besides rising air travel, the company, with Airbus, is in a duopoly with very high barriers to entry. With just $9 billion in debt and $12 billion in cash and marketable securities, it sports a strong balance sheet. The $93 billion market-cap manufacturer generated $6 billion in free cash flow last year.

Granted, its valuation hasn't fallen to fire-sale levels, but that doesn't happen too often. The stock's forward and trailing price/earnings ratios are a point or two lower than the long-term median. Boeing is cheaper than usual, compared with the market, as well.

Among Dow stocks, Doyle points out, you won't find another with a better outlook that is down as much as Boeing.

Not So Sunny in Hawaii

A big surprise this year has been a 13.5% rise in utility stocks, the best-performing sector in the first half, thanks to interest rates falling in that period. One mid-cap utility with a nice 5% yield is Hawaiian Electric Industries (HE). Investors who jump into this stock for the yield, however, should look before they leap.

HEI's 2013 results look good at first blush, but a few nonoperating items flattered last year's earnings. The utility that serves the 50th state reported net income of $161.5 million or $1.62 per share last year, up 16% from $139 million, or $1.42 in 2012.

However, Sam McBride, an analyst at New Constructs, an independent stock-research firm, says that net benefited significantly from nonoperating gains last year. For example, the utility increased the assumed return on its pension plan to 7.75%, much higher than the market average of 6.6%. This had the effect of "earning" a $10 million gain that helped net income, he says.

Similarly, 2012 results were artificially lowered by nonoperating charges, such as writedowns on assets. According to New Constructs, HEI's net operating profit after taxes (Nopat)—which strips out nonoperating gains and losses from both years—actually fell 9% in 2013, McBride adds.

The fundamental problem is that this utility has enjoyed little or no sales growth for three years, with revenue stuck around $3.3 billion. And, it faces a threat from solar power. Nopat growth has been 1% for a decade, low even for a utility, says New Constructs.

Though solar energy typically isn't competitive with power produced from hydrocarbons, the islands have a lot of sun and expensive fossil-fuel imports, making solar more competitive. About 10% of Hawaiian households use solar power.

McBride says HEI has produced about $200 million in Nopat annually for the past three years, but needs about $100 million a year for the dividend and has spent about $200 million in each of the past three years on capital investments. It's had negative free cash flow for four of the past six years, and debt increased to $1.5 billion last year from $1.3 billion in 2011. Effectively, debt is helping fund the dividend, he says.

In an e-mail, Clifford Chen, HEI's investor relations and strategic planning manager, disputes our reasons for skepticism. HEI doesn't provide cash-flow guidance but expects 2014 fully diluted EPS of $1.57 to $1.67, says Chen, who adds that EPS are up from 91 cents in 2009 and return on equity has jumped to 9.7% from 5.9% in that span.

He notes the utility business is capital-intensive and regulated and that many utilities have negative free-cash flow. As for the pension issue, he contends, HEI's approach has been consistent, is in accordance with accounting norms, and has been reviewed by its auditor.

New Constructs argues that the company's operating picture is stagnant and that, in the medium term, if HEI doesn't see gains in revenue and operating earnings greater than it recently has had, debt will go higher or the dividend might have to go lower.

Fallen Timber

What happened to Lumber Liquidators Holdings (LL) last week is a good example of how difficult it is to short stocks in a raging bull market, even if skepticism about a company eventually proves to be correct.

The hardwood-floor retailer Thursday sharply cut its 2014 EPS outlook, to $2.65-$3 from $3.25-$3.60, blaming weakening customer traffic, among other things. That day, the once-hot stock dropped to $55 from $70; it closed Friday at $54.86.

It had touched $120 last November. At that point, egg was squarely all over this column, because 18 months ago, we opined that it was expensive at $56, its price in January 2013. We said its double-digit-percent same-store sales gains weren't sustainable. The comparisons were negative-7% in the second quarter of this year, versus a 15% rise in the 2013 second quarter, right after our story ran.

Last December, we acknowledged Lumber Liquidators as our worst skeptical pick of 2013. We repeat that our negative call was too early, but last week's collapse offers a good and necessary reminder that the market can stay irrational longer than you can stay solvent.

FIVE-DAY DOW COMPOSITE

Big Less Bad: The Dow slumped 0.7% last week on profit taking, punishing small caps in particular. They dropped