TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MARKET CALLS

A Buyable Dip

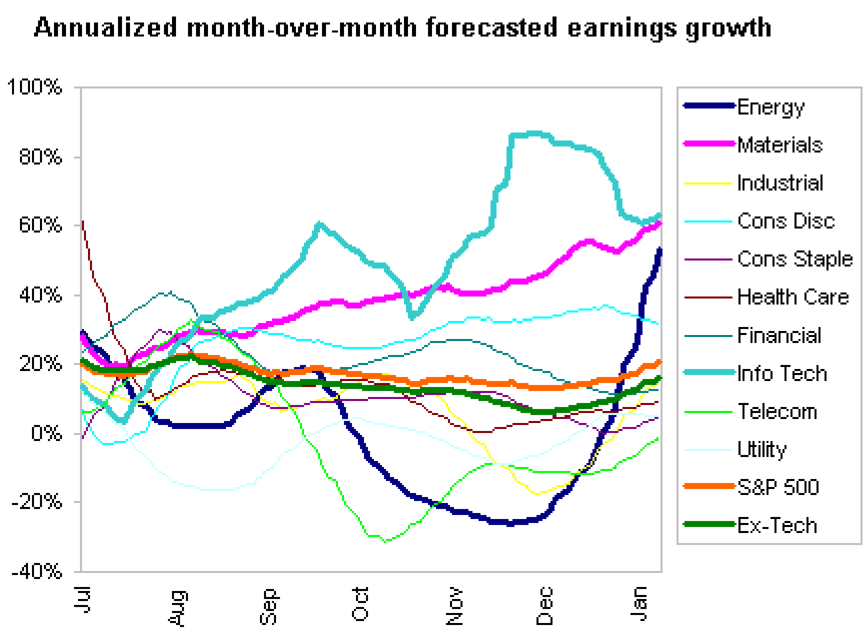
Thursday, January 29, 2004

Donald Luskin

Rising rates here won't be bad for stocks, knee-jerk reactions notwithstanding.

Like the obituary of an aging celebrity prepared years in advance and then rushed into print moments after death, pronouncements that rising interest rates will choke the economy and crack the stock market instantly followed yesterday's **FOMC** statement. We have waited for the FOMC to make such a statement for months, laying the first hints that the "considerable period" of insanely low interest rates will not last forever. We have hoped for this. We see it as a salutary step toward sanity in monetary policy. Indeed, if there's anything wrong with it, it is that it is too small a step and it should have come sooner. So a drop in equities here should be seen as a buyable dip.

For one thing, according to our valuation model, stocks are very attractively priced here. Last year's gains are offset in valuation terms by strong earnings growth, continued strong upward revisions in earnings forecasts, and the fact that earnings today are worth more on an after-tax basis thanks to last year's cut in the dividend and capital gains tax rates (see "The Tax Cut Gift that Keeps on Giving" January 5, 2004). The schizophrenic character of an economy spurred simultaneously by pro-growth tax cuts and hyper-accommodative monetary policy can be seen in the unusual combination of sectors leading the charge in earnings revisions -- growth-sensitive technology and inflation-sensitive basic materials and energy.



Given these earnings inputs, our model suggests that stocks are priced today to easily absorb as much as a 100 basis point increase in rates at the long end of the Treasury curve (which, in turn, suggests that yesterday's **Fed** news was hardly a surprise to equity investors) .

More fundamentally, it is a conceptual error to think that rising interest rates are *necessarily* bad for economic growth or for equity values, rooted in a confusion between interest rates as *causes* and interest rates as *effects*. In the absence of an activist central bank, interest rates are effects -- reflecting the real rate of return in the economy determined by expected growth opportunities

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

in relation to the supply of capital. When an activist central bank enters the picture, though, its arbitrarily administered rate causes economic consequences to the extent that they differ from the real rate.

Yes, when the central bank raises rates *above* the real rate, we would expect to see diminished growth and falling equity values. But that doesn't mean that the central bank can cause higher growth and rising equity values by holding rates artificially *below* the real rate -- because any benefits from such a strategy must eventually be paid for in inflation, which then triggers a period of artificially high rates designed to cure the inflation that the artificially low rates set in motion in the first place (see "So Much to Lose" December 23, 2003). So *increases in artificially low rates back up toward the real rate* are actually good for growth and equity values, because they reduce the risks and costs of foolhardy monetary tinkering. *That* is the situation we are in today. The real rate is, strictly, unobservable -- but it is surely greater than 1%.

Rising rates aren't the problem. The risks here are all in the other direction -- if the Fed's baby-step taken yesterday proves to be too little too late, or to the extent that there is no policy follow-through -- or *too much* follow-through when the inflationary impulses already in the pipeline start to become visible. Those risks will be analyzed in depth in a report later today by **David Gitlitz**. TM