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MARKET CALLS

A Tricky Mixture

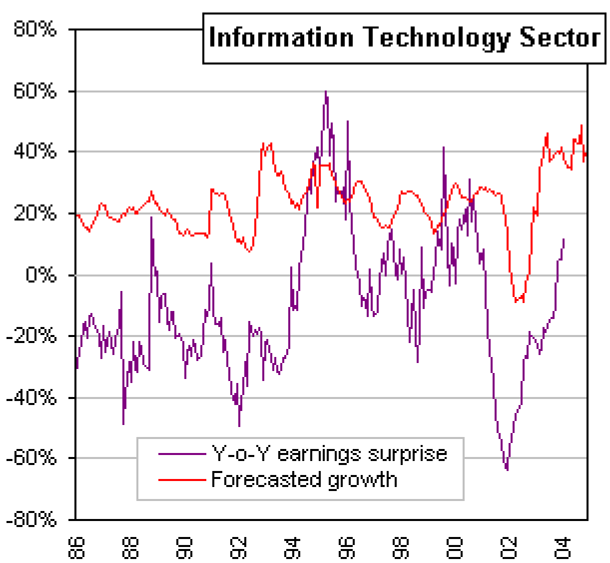
Tuesday, February 10, 2004

Donald Luskin

Equity sectors are being driven by both growth and inflation.

We suggested the day following the **FOMC's** January 28 statement that any ensuing decline in the equity market would be a buying opportunity (see "A Buyable Dip" January 29, 2004). We've been proven right so far -- too quickly perhaps, and in large part for the wrong reasons. We had hoped to see a period of misguided worry about the how the prospect of rising interest rates -- in the wake of **the Fed's** removal of its "considerable period" language -- would be bad for stocks. Instead, Friday's disappointing payroll jobs report gave the market comfort that the post-"considerable period" period may still be pretty considerable.

So the day of reckoning with rising interest rates is once again deferred, and the market continues to operate on the old punchbowl model of Fed action -- that everything will be okay until the Fed takes the spiked punch away. The reality is that the Fed shouldn't have brought booze to the party in the first place, and the sooner it takes it away, the better off the market will be.



So far the market has been driven by a strong investment-led recovery enabled by supply-side tax cuts and the end of the cycle of monetary deflation. The best evidence is the boom in the investment-sensitive **technology sector**, proving "this time it's different" by being the first sector in modern history to lead two bull markets in a row. Tech company CEO's may not be willing to speak openly of recovery in their earnings conference calls, but the numbers tell the recovery story quite clearly.

As the chart at left shows, the consensus forward earnings growth rate forecast for the tech sector is at record highs. Yet actual earnings for each of the past three months have nevertheless managed to surprise to the upside. This is all the more impressive when you consider that, historically, earnings have tended to *disappoint* by more than 10% on average in this sector. For all that, the cap-weighted technology sector is priced essentially at fair value. The S&P 500 ex-tech, by contrast, is notably *under*valued -- but even relative to that, tech is as cheap as it has been in more than 2-1/2 years.

While we see the tech sector as emblematic of the fundamental growth drivers of the equity market, there are other sectors that reflect both growth *and* incipient inflationary pressures at the same time. The **basic materials sector** is also showing record earnings growth forecasts. While the sector has yet to deliver upside surprises against those forecasts, the forecasts are nevertheless being revised higher at a faster rate than those of the tech sector. Growth

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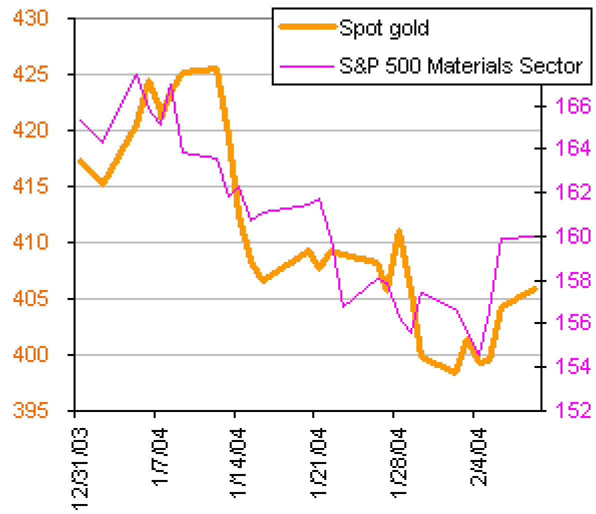
forecasts in the other most inflation-sensitive sector -- the **energy sector** -- are soaring, being revised higher at an even faster rate.



While growth forecasts continue to rise, prices of basic materials stocks have moved year-to-date in perfect lockstep with the price of gold (see the chart at right). Now with materials stocks off their January peak while earnings forecasts are rising, the sector has become modestly undervalued according to our model, for the first time in nine months.

At best, we see the Fed beginning soon to gradually move to correct its overly easy policy stance. With luck, this would stop the acceleration of inflationary impulses, and we would have to deal with only the inflation already packed in the pipeline -- probably an increase of not more than a couple percent from the current pace around 1% in CPI terms. When the Fed gets started on that move, Treasuries will be hard hit, and stocks will go through that "buyable dip" we've been talking about.

From here it seems virtually inconceivable that the Fed could actually reverse any already pipelined inflationary impulses and hold the CPI at its present low level (indeed, we don't believe the Fed even wants to do that). So we continue to expect the best performance from a "barbell" equity sector strategy straddling the Old and New Economies, favoring simultaneously the growth-sensitive tech sector and the inflation-sensitive basic materials and energy sectors.

If, on the other hand, the Fed gets even more stubborn here -- or "patient" as they would say -- then we'll have to seriously consider a 1987 *deja vu* strategy in which the key call would be getting out of stocks at just the right moment, before it's too late (see "*'It'* Can Happen Here" January 15, 2004). TM