TrendMacrolytics

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MACROCOSM

Measured

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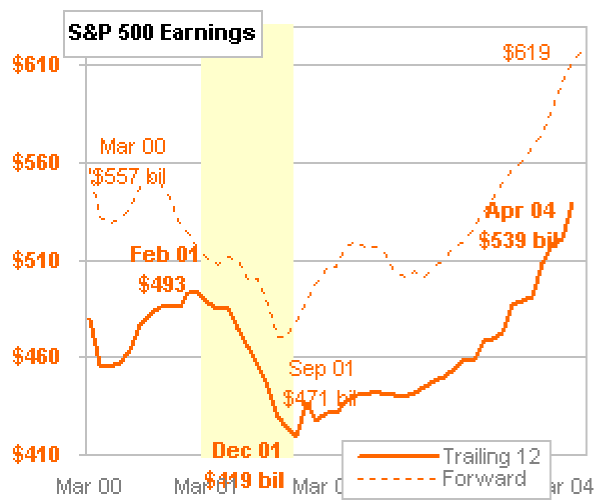
Bonds lose, stocks win.

In some sense **Alan Greenspan** couldn't have come up with a more stock-friendly word than "measured" in yesterday's **FOMC** statement. The stock market doesn't seem to have entirely realized just how good that word is.

Treasuries are toast, no matter what Greenspan says. At this point, "considerable period," "patient" and "measured" are all euphemisms for "inevitable." It's inevitable that **the Fed** will hike rates -- the unnaturally low rates that it has employed deliberately to keep Treasury yields low through the arbitrage mechanics of the "carry trade" (see "A Considerable Seduction" December 16, 2003). On the other side, the longer the Fed waits, the greater the inflationary acceleration. Either way, there's no way out for bonds.

But it's different for stocks. Yes, stocks are bond-like to the extent that future earnings have to be discounted at bond-like rates. But more than anything else, when you strip away all the formalities, stocks are about growth. In that sense they are quite *un*bond-like -- indeed, to that extent the interests of stocks are in conflict with the interests of bonds. A "measured" removal of monetary ease -- a prompt and orderly retreat to normal levels of interest rates that reflect the growth rate of the underlying economy -- is the most growth-optimal path we could possibly hope to walk under today's circumstances. Stocks win, bonds lose.

That's why we've been saying since forever that bonds are a catastrophe waiting to happen, and since early this year that equity investors should take every opportunity to buy pullbacks motivated by false fears that rate hikes would abort the economic expansion (see "A Buyable Dip" January 29, 2004). At the least, given the extraordinary continuing underlying strength of the economic expansion and its impact on corporate earnings, we would expect to see stocks move back up through this year's trading range (see "A Buyable Consolidation?" April 28, 2004).



We continue to be wary, however, that equity valuations are being driven to an important extent by expectations about the probabilities for **George W. Bush's** re-election, and the eventual renewal of his pro-growth tax cuts. On the good side there, Bush's probabilities have stabilized at about 60% for several weeks now despite a nearly unimaginable cascade of damaging news about **Iraq**, and a disturbing absence

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of leadership messages from the president. Clearly the palpably vigorous economy is working for him, but just as important it seems that **John Kerry** has failed to come up with his own competing leadership messages. This unstable situation commands a continuing risk premium in the most growth-sensitive sectors, so we remain concerned that high-multiple stocks will have a hard time "earning their beta" for the immediate future, even in the context of an overall rally.

The single most important key now is for the Fed to *follow through*. The biggest risk in rate hikes is that they won't happen. We can't ignore the possibility that some spurious piece of negative macroeconomic data will come out and give the Fed the excuse to stay too easy for even longer than it already has. Friday's payroll jobs number, then, is extraordinarily important: a bad one will make last month's good one look like an anomaly, while a good one establishes a trend (that's insurance -- a bad one *next* month would then look like an anomaly). Two-in-a-row on jobs would be a boost for Bush, as well, so look for a possible double-win for stocks tomorrow, though of course the first reaction may be negative, thanks to those who are still living in the low-rates-forever cocoon. We expect another very good jobs number based on virtually every indicator of economic growth that we see -- but we've learned never to underestimate the power of this statistic to underestimate.