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Unlocking "The Bush Rally"

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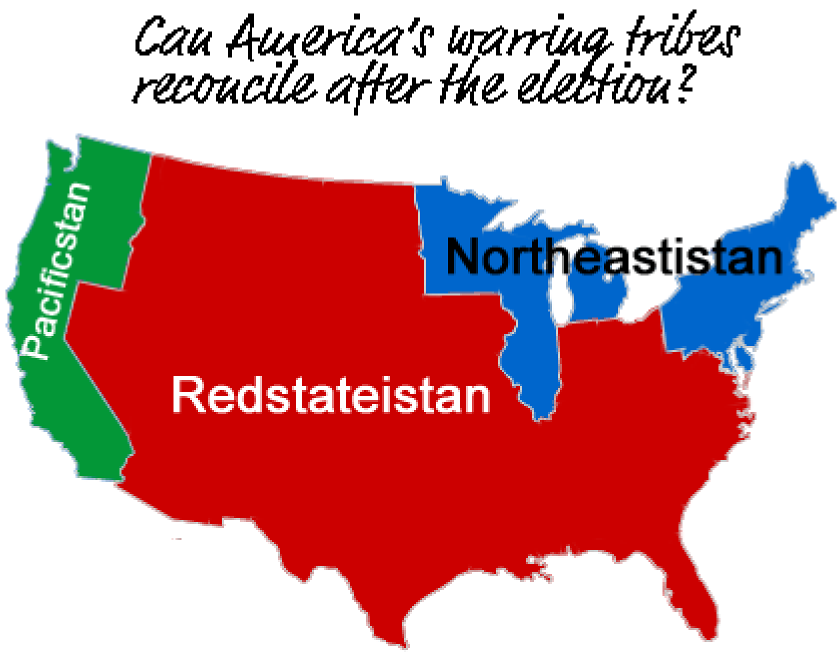
Election: click. Oil: click. Economy: click. The Fed: clunk!

We've said many times this year that the election had captured the market in a "bubble of fear" (see, most recently, "Don't Miss the Obvious" November 2, 2004). That bubble's post-election bursting has powered what the popular financial media are now calling "the **Bush** rally." But it's more complicated than that. Going forward, rather than a bubble bursting all at once with a simple pin-prick, let's think of a lock being released one tumbler at a time. We expect the rally will continue for some time, with the occasional setback along the way, of course, as more tumblers fall into place -- some easily, and some not so easily. While stocks have rallied from the point of near-historic undervaluation that we noted before the election, there is still a lot of room on the upside.



But the simple part is behind us. It was rational for the market to impound a risk premium for the sheer uncertainty of who will be the next president, and the risk of a litigated election. That's behind us now. Of the starkly different outcomes that were possible, we got the best -- the more pro-growth candidate was re-elected with a decisiveness beyond the "margin of lawyer." In fact, it was better than the best -- the more pro-growth party also expanded its control of both houses of **Congress**. Thus, "the Bush rally."

So now it's on to other tumblers that have yet to fall into place. The rest of them are more complex ones, because they deal with the unwinding of fears and uncertainties that were not entirely rational in the first place -- exaggerated fears of imminent terrorist attacks, impending economic catastrophe and so on. We have argued that these fears were deliberately induced by politicians and the media in order to achieve partisan advantage. You might think that an efficient market wouldn't pay heed to such things, but when lies are repeated often enough by authority figures, they begin to take on a life of their own. If nothing else, the mere fact that so many lies are being told by such people is itself something to be feared -- because it creates a counterproductive climate of factionalism and distrust. While we have no illusions that we are now about to enter a new era of bipartisan comity, we are confident that the divisions that showed so sharply during the election can now begin to heal to some meaningful extent.

A key tumbler already falling into place is oil. The price of crude was driven to record highs three weeks ago, finding itself at the intersection of all manner of politically charged fears -- potential terrorist attacks, **China** taking over the world, **OPEC** losing control of the market, no national energy policy, "missing barrels," "**Hubbert's** peak," and so forth, *ad infinitum* and *ad nauseam*. The **Bush administration** stoked these fears during the election by steadfastly refusing to draw down stocks from the **Strategic Petroleum Reserve** as two previous administrations had done under similar market circumstances, citing national security concerns (perhaps they will feel differently now). At $55 -- or, for that matter, even at today's lower price of $48 -- oil is priced ludicrously above the marginal cost of exploration and extraction. There is no current production deficit relative to consumption demand, and at these prices new capacity is being brought on at a furious pace. Fear-driven oil markets have been motivated not by true scarcity, but by hoarding demand and speculation.

As we have been expecting (see "Broken?" October 15, 2004), with the political motives for fear-mongering in the oil market rendered obsolete by the election, speculation and hoarding seem to have crested, and the price is already off more than 10% from the highs. We expect it to continue to fall, generally, for the rest of the year. Just as fear-driven oil price increases acted as a self-fulfilling prophecy to some extent with respect to similarly fear-driven predictions of an economic slowdown, now oil price *decreases* will do the same in reverse as they help the economy re-accelerate at the same time as confidence is gradually restored.

A more complicated tumbler -- one that has hardly even begun to fall into place -- is **the Fed**. So far the Fed has moved far too slowly to normalize interest rates. Has its perception of the strength of the economy become caught up in the pre-election "bubble of fear" -- or has it hesitated to act more decisively because it senses that confidence in the economy has been, rightly or wrongly, quite fragile? Either way, the Fed has fallen behind the curve, and the consequence of that is an acceleration of inflation that has already begun. Indeed, high oil prices are in part due to accelerating inflation (oil, priced in euros, is about where it was three years ago). With the dollar making nine-year lows, gold making 16-year highs, and core CPI having nearly doubled since year end, **the FOMC's** Wednesday statement that "Inflation and longer-term inflation expectations remain well contained" rings rather hollow.

Fed officials have made several recent statements to the effect that they are not overly concerned by the dollar's weakness (see "Dollar Delusions" October 26, 2004). Yet, with one more FOMC meeting remaining this year, there remains the hope that other factors may quickly move the Fed to constructive action -- even if for the wrong reasons. Further evidence of economic re-acceleration (such as last week's robust payroll jobs report and today's strong retail sales report), falling energy prices, rising equity valuations, and re-invigorated confidence may be all that is required to get the Fed to take what ought to be simple steps back to merely normal levels of interest rates.

Until that happens, a key tumbler remains unengaged and the full potential of "the Bush rally" remains locked up. Yes, the headlines all say that a still-easy Fed ought to be just what stocks want. And if and when the Fed wakes up and gets more aggressive, those same headlines will no doubt say that stocks are put in peril. But as usual, the headlines have it backward. A too-easy Fed is a risk to stocks -- and the falling dollar ought to be seen as a loud and clear signal of that risk. The equity risk premium remains so deep, and the other tumblers are falling into place so well, so we are far from ready to say that an errant Fed has killed "the Bush rally" while it's just beginning. But right now the Fed is at best a wild-card, and at worst a threat. A vigilant Fed, on the other hand, can be the stock market's best friend. And if "the Bush rally" falters someday on news that the Fed is finally getting engaged, then that would be a stellar buying opportunity. TM