TrendMacrolytics

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We've Only Just Begun

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There's still air in the "bubble of fear" -- and room on the upside for stocks.

Markets continue to reabsorb the risk premia accrued during the "bubble of fear" engendered by the presidential election. Stocks have moved to new recovery highs off the March 2003 bottom. Growth is in the lead, with our two favorite equity sectors for the recovery -- Technology and Basic Materials -- in first and third place respectively since the year's bottom on August 13 (Consumer Discretionary nudged Materials out of second place just yesterday).

It's not over yet. With the S&P 500 now up just 7% year-to-date, stocks are not done pricing the more than 23% increase in earnings already booked this year. Beyond that, the economy is now reaccelerating after an overhyped "soft patch," so there will be more earnings gains to come. As we learned last night from **Intel's** mid-quarter review, even given-up-for-dead tech giants can surprise on the upside when growth starts to get back into high gear.

All the elements of deflation of the pre-election "bubble of fear" are falling into place. As we have expected, crude oil prices have definitively cracked, as fear-driven hoarding and speculative demand has begun to unwind. And as we have hoped, it seems that even **the Fed** is starting to act less afraid. All year the Fed has apparently believed that nervous markets had to be shielded from the truth about the gathering threat of inflation. But now there are signals that the Fed intends to be more vigilant in the future, with Fed officials leaking to yesterday's ***Wall Street Journal*** their internal debates about how to shift to more inflation-aware language in upcoming **FOMC** statements. Taking these two elements together makes for a *very* positive development. The most dangerous risk to the expansion has been the possibility that an overly dovish Fed would accommodate high oil prices, as it so disastrously did in the 1970s. Now, the combination of falling oil prices and a more hawkish Fed potentially moves us away from that risk. It's bad for bonds, which seem to have already begun sniffing out this development over the last week -- but it's great for the durability of the expansion, and for stocks.

Another factor that gives us confidence that the "bubble of fear" will continue to unwind, and continue to drive stocks higher, is that we still sense a great deal of fear among market participants. Just look at how much trouble the Wall Street analytical fraternity is going to this morning to worry away Intel's good news -- and no doubt this morning's slightly disappointing jobs number will be played for all its worth. Near the end of a week on the road talking to investors, it feels almost as though there is no possible worry we haven't heard expressed -- including every imaginable dollar catastrophe scenario, and even the concern from several investors that *other* investors are too optimistic! How different it is today from early 2002, those patriotic post-9/11 days when dreams of a "super-V" recovery were all the fashion among Wall Street economists. Sure, the nabobs at the **National Bureau of Economic Research** subsequently declared that the recession troughed in November, 2001. Cold comfort for the bulls: the S&P 500 still had more than 30% to fall over the following several month, viewed from its heights in early 2002. Now, almost three years later, the S&P 500 has finally surpassed its

January 2002 levels, and the economy is tangibly reaccelerating from already brisk growth rates. Yet no one is assigning letters of the alphabet nor superness to this recovery, which tells us that there is nothing like a 30% decline in our near future. Quite the contrary.

We freely acknowledge that stocks aren't as historically cheap as they were in the late summer when the "bubble of fear" was at full flower. But there's still plenty of fear left to come out of that bubble, now that it's burst. That means stocks still have lots of room on the upside -- and oil and bonds still have a long way to fall. TM