TrendMacrolytics

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Back To Square One

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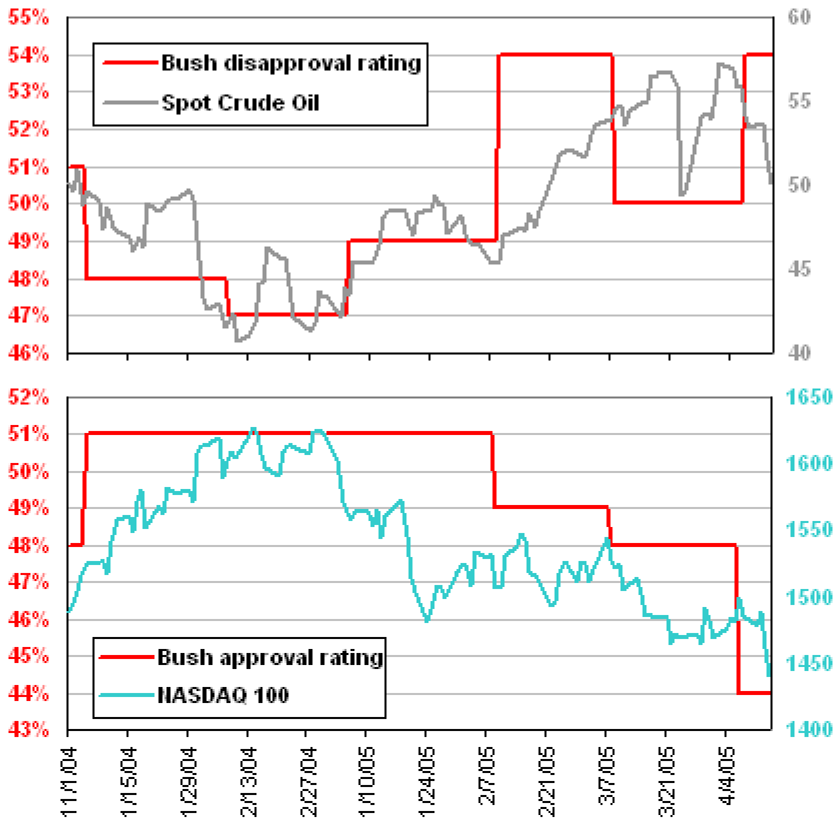
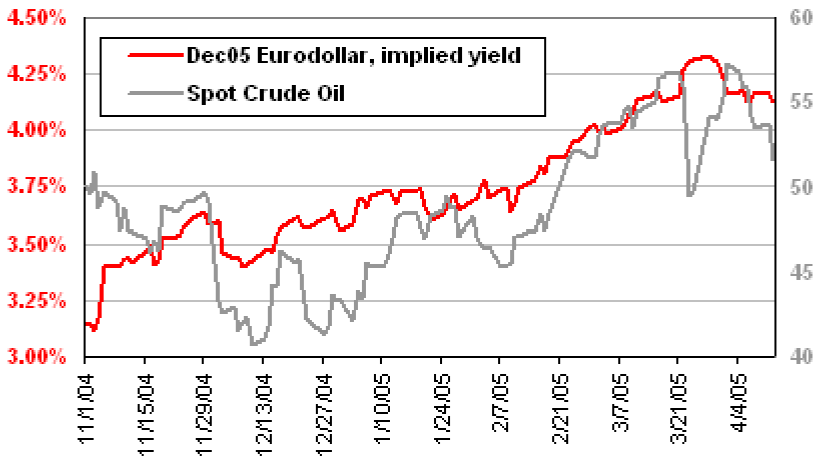
In growth-sensitive markets now, it's as though the presidential election never happened.



The price of **crude oil** stands almost exactly where it did the day before the presidential election, exerting a drag of unknown dimension on the economy. The critics must have been wrong when they said the war in **Iraq** was "all about oil" -- we're wining the war, so where's the oil? A lot of it is locked away in the **Strategic Petroleum Reserve**. **President Bush's** disapproval ratings are now at all-time highs.

Stocks have fallen almost all the way back to right where they were the day before the election. In fact, the growth-sensitive **NASDAQ 100 Index** is lower. Bush campaigned on making the pro-growth 2003 tax cuts permanent. But now, after winning a decisive re-election and expanded majorities in both houses of **Congress**, it looks now like those tax cuts will be extended for just two years. And while we stand around waiting for even that to happen, the acrimonious debate over **Social Security** has put tax *hikes* on the table, and given the opponents of growth the opportunity to bring back last year's partisan bitterness -- literally, with a vengeance. President Bush's approval ratings are now at all-time lows.

These are not the only crises of pro-growth leadership that markets now have to contend with. **The Fed** has kept interest rates too low for too long, and was finally forced by rising oil prices to face up to the inflationary consequences. Since the Fed finally went public with its inflation concerns at the last **FOMC** meeting, the most inflation-sensitive markets have responded in the right direction, if not in great magnitude -- **gold**, **commodities** and oil are somewhat lower, and the **dollar** is somewhat higher. Yet **Treasury bond** yields today are *lower* than they were the day of the last FOMC meeting, and expectations in the **Eurodollar futures** markets for the



year-end fed funds rate have *fallen*. Bonds would appear to believe that an indecisive Fed will abandon its new-found inflation fighting zeal at the first sign of economic weakness -- or perhaps at the first sign of success in reversing the trends in gold, commodity, oil and the dollar.

So in some sense it's back to square one for pro-growth policy. Objectively, surely there's less risk to growth today than if **John Kerry** had been elected, of than if **Alan Greenspan** hadn't acknowledged the risk of inflation at the last FOMC meeting. But the markets feel as though they thought those things had never happened. As a consequence, stocks are now undervalued relative to bonds more deeply than they were the day before the election -- based on comparing consensus forward earnings yields to long-term Treasury bond yields. They are undervalued more deeply than they've been at any time in the last 20 years other than the panic bottoms of October 2002 and March 2003, with the growth-sensitive **Information Technology** sector far more undervalued than at either of those bottoms. And that creates what Alan Greenspan would call a conundrum.

If stocks are priced correctly, then the forward earnings consensus is way too *high* -- it would take a reversal from expected year-ahead growth of 11% to 19% *negative* growth to explain today's stock prices. Or, interest rates are way too *low* -- the current long-term Treasury yield of 4.72% would have to rise to 6.51% to explain today's prices. Or it could be a combination of both -- say, zero earnings growth and yields at 5.5%. No matter how you slice it, the expectation seems to be for a hyper-aggressive Fed to throw the economy into recession by rapidly hiking interest rates.

But then, if stocks really are priced correctly, then there are two important implications. First, bonds must be priced *very incorrectly* -- today's yields certainly don't anticipate a hyper-aggressive Fed. Second, when the earnings collapse and/or rate increase implied in stock prices occurs, stocks will -- by definition -- have already entirely priced it in, and there would therefore be no room on the downside.

What if we stipulate that *bonds* are priced correctly? Then stocks are priced *incorrectly*, unless we really believe that earnings will fall 18% over the coming year. Yes, if earnings fell like that, no doubt the Fed would pull back its inflation-fighting horns and act very much like the bond market seems to be expecting it to act. But despite the ritual annual re-emergence of recession fears -- and a couple bad weeks for **IBM** notwithstanding -- we don't think that anything remotely resembling an earnings collapse is in the cards.

Bottom line: The present atmosphere of fiscal and monetary policy uncertainty is bad for stocks and bad for growth. But while considerable risks remain -- and there is some real disappointment in that fact -- there is *less* risk in all policy domains than there was before the election, and we continue to expect that today's policy uncertainties will resolve more favorably than markets are pricing for. Worries that have infected the market in recent days that the economy is heading into a “soft patch” or “growth pause” are likely to wind up being seen as significantly overdone. While the 4%-plus real GDP growth we've had recently is not likely to be sustained indefinitely (it never is), there is little in current conditions suggesting to us a major trend shift in economic performance. We reiterate our view that the stock/bond conundrum will be resolved, soon enough, in both higher stock prices and lower bond prices. If stock valuations get much cheaper, at levels like those seen in October 2002 and March 2003 we would have a major buying opportunity.