TrendMacrolytics

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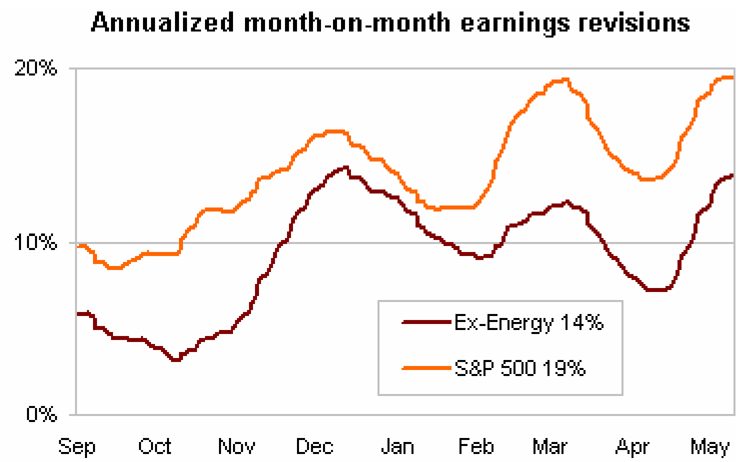
Stocks are telling us that inflation risk is moderating, rates are rising, and that growth will be steady.

10-year Treasury bond yields below 4% are discounting zero **inflation**, no more **Fed rate hikes**, a **recession**, a **SARS** epidemic, and three nuclear wars. As we suggested yesterday, **stocks** are telling a considerably more nuanced story (see "Brave New World?" June 1, 2005).

Stocks are telling us that the worst-case inflation scenario is off the table. After the Fed went formally on inflation-watch at the March **FOMC** meeting, we reversed what had been our long-standing bullish view on the positively inflation-sensitive **resource sector**, including **Energy** and **Basic Materials** (see "The End of a Theme" March 29, 2005). Since then, Energy and Basic Materials have been the two worst-performing **S&P 500** sectors (up only 0.7% and down 4.5%, respectively, versus the S&P 500's gain of 3.2%). We also suggested then that **small cap** stocks would end their long streak of outperformance versus **large cap**, noting that historically the small stock premium has been highly correlated to increasing inflationary expectations. Since then, the **Russell 1000** has outperformed the **Russell 2000** (3.6% versus 3.2%, respectively). Yes, there's more pipelined statistical inflation to come through the backward-looking **CPI** and similar measures. But stocks are clear that, looking forward, the worst case is in the process of being averted.



Stocks are telling us that there is no recession coming. Yes, we have been noting for a long while that stocks overall are deeply undervalued relative to bonds. But intersectoral dynamics don't support the idea that general undervaluation is an implicit recession forecast, with **large cap growth** stocks turning in the best performances. With the worst-case inflation scenario off the table, we predicted that these negatively inflation-sensitive stocks would be the prime beneficiaries. Since then, **Information Technology** and **Health Care** have been the second and third best performing sectors (up 5.8% and 5.4%, respectively). At the same time, bottoms-up consensus earnings forecast revisions have been running sharply positive. The annualized rate of month-on-month revisions is now running at 19.4%, the highest value so far this year. Even excluding the Energy sector, annualized revisions are running at 14.0%, almost matching their elevated level seen at last year-end.

Stocks are telling us that the price of contained inflation is higher interest rates. We have been saying for quite a while that stocks are steeply undervalued relative to bonds, based on **earnings yields** versus **coupon yields** -- but we don't see this as a recession forecast. This wide risk premium is surely explained in part by policy risks facing the economy (see "Ducked Bullets" May 20, 2005). But we suspect that stocks, which are expecting moderating inflation risk, have more than discounted higher interest rates as part and parcel of that expectation. Today, according to our model, stocks are priced for an instantaneous hike in long-term Treasury yields of 212 basis points. We don't expect anything of that magnitude, but it's clear to us that stocks are listening to **Donald Kohn**, a Fed governor and veteran **Washington** staffer, when **Bloomberg** reported him saying that interest rates "still need to rise" -- that they are "still too low to maintain 'stable inflation.'" Bonds, on the other hand, are listening to rookie **Dallas Fed** president **Richard Fisher**, who blurted to **CNBC** that the Fed is in the "eighth inning" of its rate-hiking program. So stocks are from Washington, and bonds are from Dallas.

Bonds are wrong. As we said yesterday, "we don't think the bond market is right." Stocks can see that bonds are just the lucky lottery winner in this particular inflation cycle -- along with **oil** inventories, **housing**, **art** and all the other **"carry trades"** *du jour* -- simply the place where all the excess liquidity happens to be going. In the last inflation cycle that started in 1986, it happened to be stocks (and you remember how *that* ended). It is possible that the Fed will soon come to worry that the bond bubble it created represents, in and of itself, an inflationary threat. Bonds are the Fed's inflationary **Frankenstein's monster**, deliberately brought to life by the "considerable period" of low fed funds rates, conceived to combat **deflation** when the Fed was thought to be "out of bullets." Fed governor **Ben Bernanke** revealed the Fed's strategy in his famous November 2002 speech *Deflation: Making Sure "It" Doesn't Happen Here*, when he said that "a determined government can always generate higher spending and hence positive inflation... stimulate spending by lowering rates further out along the Treasury term structure--that is, rates on government bonds of longer maturities." In a deflation, lower bond yields were our friend. Now, in an inflation, they are our foe. So what does our "determined government" have to do now? Stay on a **"measured"** course of rate hikes through the end of the year. So if we are in any kind of eighth inning here, it is the eighth inning before bonds have their own private little October 19, 1987.

Bottom line: Stocks are forecasting moderating inflation, steady growth, and higher interest rates. So it's death to carry trades. Ironically, that makes stocks themselves the only good carry trade in town. If you sell long term Treasuries and use the sales proceeds to buy the S&P 500, you get an implied carry income of 2.20% per year as of yesterday's close, based on consensus forecasted earnings yields. So who cares how long it takes the bond bubble to burst? Every day we wait we earn 2.20% per year on an investment of zero. In fact, if we are wrong about bonds and the bond bubble *never* bursts, one might say "so much the better." Doesn't the conventional wisdom argue that stocks should like low interest rates as far as the eye can see?

Briefly noted: On Tuesday we witnessed the grand irony of **President Bush** criticizing **Russia's** show-trial of **Mikhail Khodorkovsky**, only to have the **Supreme Court** overturn the conviction of **Arthur Anderson** in *its* show-trial moments later. On Wednesday, Bush accepted the resignation of **SEC** commissioner **William Donaldson**, one of **America's** chief show-trial impresarios. Today he nominated **Christopher Cox** -- an admirable pro-growth **Republican** congressman -- to replace Donaldson. With Donaldson out and **Eliot Spitzer** headed for the governor's mansion, perhaps we can look toward the end of the era of regulation by *jihad*. File this under "long term" -- but it could be very important and very good. TM