TrendMacrolytics

Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

MACROCOSM

Water In The Streets

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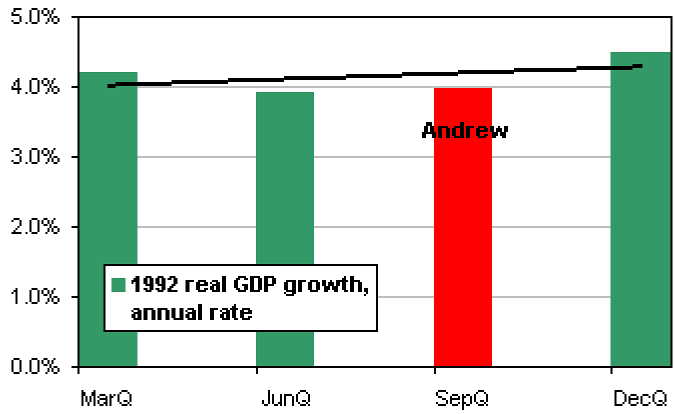
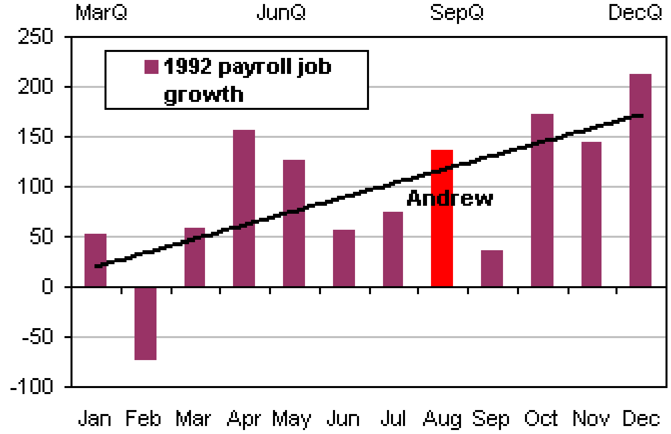
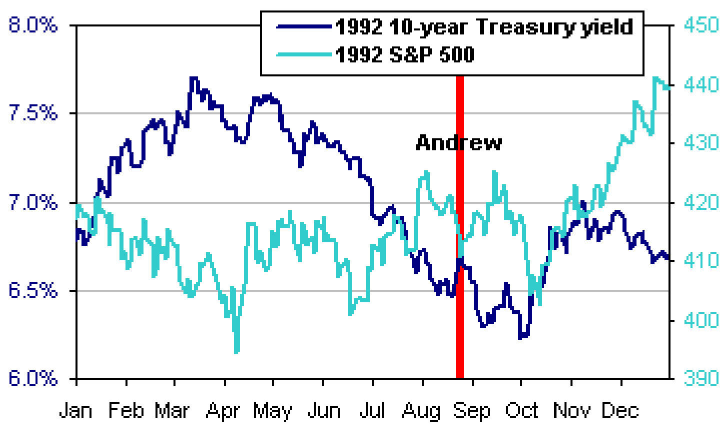
Donald Luskin

Katrina could trigger overdue revaluations in stocks, bonds, and oil.







The devastation of **Hurricane Katrina** didn't quite create the most classic of all **stock market** buying opportunities--"when there's blood in the streets" -- with stocks driven to unsustainable lows by dint of sheer panic. Tragically, there *is* blood in the streets of **New Orleans** -- not just a great deal of water. The horrors and the costs, and the disruption of **energy** extraction, refining and distribution, could have crashed stocks -- but they didn't budge them. In fact stocks are higher as of this writing than they've been in more than two weeks, before Katrina was even a blip on a radar screen. It goes to show that stocks have been, exactly as we've said so often, priced for the worst. When stocks come into a situation like this a near-record 50% **undervalued** in terms of **forward earnings yields** and **interest rates**, then when the worst finally happens, it comes more as a relief than anything else. The same thing could be said in reverse about the **overvalued crude oil** price. At this writing it's not much higher than last week's pre-Katrina highs. For both stocks and oil, we may very well be seeing the last gasps of exaggerated pessimism.

While the energy **supply shock** angle makes Katrina distinct from past experiences, it's still useful to review what happened in 1992 after **Andrew**, an approximately comparable hurricane. Pretty much nothing did. **Real GDP growth** wasn't much below trend in the

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 552 3625

quarter that included Andrew, and it bounced above trend in the following quarter. **Payroll jobs** took a hit in September (Andrew occurred in the last week of August), but rebounded strongly in the following three months. Stocks had been declining for several weeks prior to the hurricane, just as they had been this year. As soon as Andrew passed, stocks rallied -- again, just as they have this year.

The Fed did nothing in the wake of Andrew -- the **funds rate** was 3% when the hurricane struck, and it didn't budge in response. Yet **10-year Treasury bond yields** fell 50 basis points in the five weeks following Andrew. That move was more than reversed by year-end as the Fed held steady. We'll be writing much more about this most critical element of today's situation, but in a nutshell we think that the Fed is highly unlikely to interrupt its **"measured"** march back to a **neutral** funds rate of 4.25% or higher. We're now seeing an outpouring of triumphalist public statements from **bond bulls** claiming the "the Fed is done." They're wrong. In fact, the worst risk facing stocks now is the possibility that the bond bulls are right. Stocks reached their highs in early August at the same time that expectations for continued **rate hikes** reached their highs, too. Stocks need to know that the Fed will stay vigilant against **inflation** *now*, to avoid the risk of **shock treatment** *later*. Stocks need to see the same thing they saw in late 1994, which launched an enormous rally -- that the Fed is not only "done," but that its inflation-fighting job is done, too.

Bottom line: Markets have been priced for the worst, and a version of the worst has happened. Undervalued stocks were unfazed, and may well be in a position to rally further here as extraordinary circumstances trigger a **reappraisal** of the **equity risk premium**, now just basis points away from record levels. Overvalued oil was unfazed, too, and may well pull back considerably here as **speculators** digest the meaning of its failure to establish and hold the significantly higher levels they had been hoping for. Overvalued bonds, on the other hand, have taken the opportunity of Katrina to become even more overvalued, based on highly unrealistic expectations of Fed inaction. There are **value realignments** to come in all three markets, and bonds are sure to get the worst of it. TM