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Why Rates Can't Clock Stocks

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How can stocks and interest rates make new highs at the same time?

One conundrum of the yield curve that **Ben Bernanke** didn't mention in his speech Monday night is: how come stocks are so resilient in the face of a **Fed tightening cycle** that so far shows no definitive sign of a endpoint? One answer is that the sequence of 14 back-to-back Fed **rate hikes** since June 2004 hasn't been a *tightening* cycle at all. It has been a ***normalizing* cycle**, so far bringing the **fed funds rate** nowhere near the 6% average of the last half century. The fact that today's ***real* funds rate** at 2.4% is slightly above the 50-year average of 1.8% says more about the official under-reporting of **statistical inflation** than it does about Fed **policy**. At that, 2.4% is nowhere near the 4% real rate where, historically, a risk to **economic growth** has begun.

Another answer is that **ultra-accommodative** interest rates are simply not necessary for continued **expansion**. They are not a medicine required to keep an otherwise sick economy alive, but rather they were a temporary crutch required to help an otherwise healthy economy through a temporary adversity. Indeed, that adversity was caused in the first place by **ultra-restrictive** interest rates in 1999 and 2000 -- so the **"considerable period"** of low rates can be seen as just the reversal of a previous **deflationary error**. Bernanke said it himself Monday night: "The goal... was to help ensure that the economic expansion would be self-sustaining and to protect against...outright deflation." Mission accomplished.

Still another answer is the sensitivity of stocks to **inflation risk**. Even though stock prices and earnings are **nominal** quantities, inflation both erodes **earnings quality** and implicitly raises the **capital gains tax rate** (which is not **indexed** for inflation). The Fed's present normalization of interest rates is an urgently required move to limit the inflationary impulses embedded during the "considerable period" of ultra-accommodative rates.

Yet another answer is to note that **long-term bond yields** are near four-year highs, but that only means that the capability of the economy to provide **debt capital** is no less today than it was four years ago. In other words, even though **short-term rates** have risen considerably, the **flat yield curve** and **narrow credit spreads** indicate that further growth will be fueled by a continuing propensity to bear risk. We've made this point many times (see, for example, "False Positive" January 3, 2006). And Bernanke said it himself Monday: "...to the extent that the flattening or inversion of the yield curve is the result of a smaller term premium, the implications for future economic activity are positive rather than negative," and "corporate risk spreads, would seem to be consistent with continuing solid economic growth." This, by the way, was precisely the view we forecasted last year that Bernanke would take (see "Bernanke's Conundrum" December 20, 2005).

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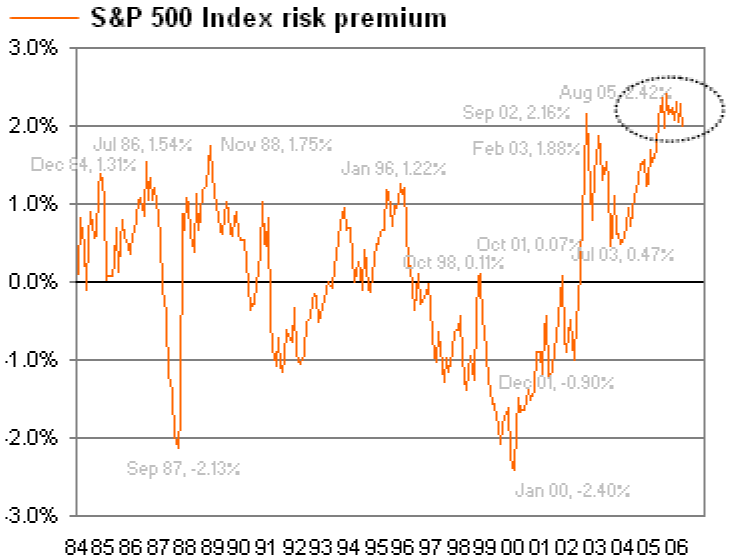
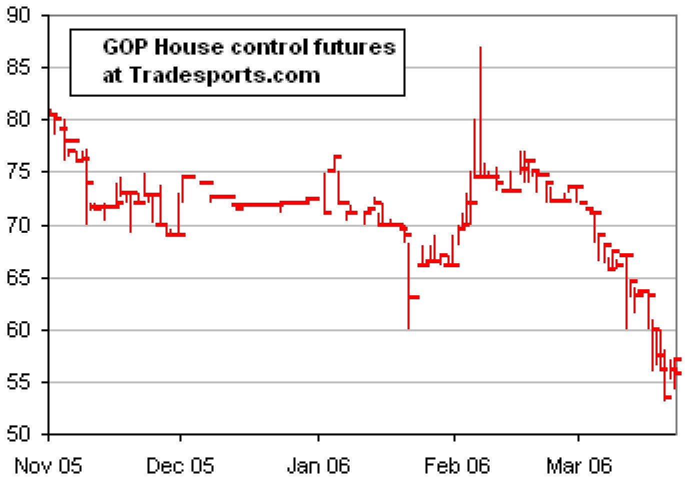


Another answer is to note that, while stock prices have rallied back to about where they were five years ago, **equity valuations** surely have not. Stocks are dirt cheap. Since five years ago, **S&P 500 consensus forward earnings** have risen 60%, yet stock prices are no higher. Measured against those earnings in relation to long-term **Treasury** yields, the S&P 500 **equity risk premium** has been stuck in a narrow band at historically low equity valuation for the last 12 months. There is no precedent for valuations to remain in such a narrow band for so long -- and certainly not at such extreme levels. We've been saying for the entire period that this extremity means that stock prices are robust to all but the most catastrophic interest rate shocks (see, for example, "The King of Carry Trades" June 14, 2005).

Finally, the resilience of stocks may reflect the absorption of gradually evolving good **economic policy news**. We have already noted that we think stocks may be finally taking cognizance of the glacial yet relentless progress toward **extension of the 2003 tax cuts on dividends and capital gains** (see "Extending Visibility" February 17, 2006). And if we read the tea leaves correctly, it seems that **protectionist threats** against **China** in advance of **President Hu's** April visit are dialing back a bit (see "Tsunamis! Killer Asteroids! Protectionism!" April 21, 2005). After a junket to China this week, **Senator Lindsey Graham** -- whose bill co-sponsored with **Chuck Schumer** would slap a 27.5% **tariff** on all Chinese goods unless China dramatically **revalues** the **yuan** -- was quoted today as saying, "I am very flexible because I now understand the dynamics of revaluation as how it affects the Chinese economy much better."

If those are all good reasons why stocks aren't going down, then why aren't they going up with more vigor? First and foremost, while stocks and the economy should welcome the normalization of interest rates, there remains the risk that the Fed will go beyond normal all the way to tight, especially if it misinterprets continued economic vitality as **"overheating."** We are somewhat comforted on that risk -- at least at the margin -- by the clarity, subtlety and depth of Ben Bernanke's grasp of issues, which his virtuosic speech Monday clearly displayed -- the **mainstream media's** perplexity on that speech (see "Learning Curve" March 21, 2006) only confirms to us that Bernanke is on the right track. But there's no escaping the reality that his intellectual touchstone for **monetary policy** is the flawed **neo-Keynesian** notion that inflation is the creature of **excess demand** (see "Is Ben Bernanke a Phillips Head?" March 1, 2006). When short-term rates get all the way to normal this summer, and the economy continues to grow robustly, we'll see whether Bernanke's touchstone will be the economy's gravestone.

Another risk factor that's keeping stocks cheap is the growing possibility that the **Republican party** will lose its **majority** in the **House of Representatives** (see "Election Risk: It's Back" January 26, 2006). Since its February high following the election of **John Boehner** to **majority leader**, the online futures contracts on **GOP house control** traded at **Tradesports.com** have fallen to new lows, just above 50%. Frankly, we are surprised that stocks have done as well as they have in light of this dramatic reappraisal. Make no mistake about it -- if you thought it was difficult eking out **pro-growth policy** with the GOP controlling the House, just wait till you see how hard it will be with the **Democrats** in control. Perhaps the best hope here is that the House



control futures will be "wrong" in the same way that **gold** was "wrong" when it traded at $850 in 1980, just when inflation was about to top out. Gold was then, and the futures are now, urgent alarm signals which, if heeded, will prevent the very future they are warning about.

Bottom line: Deep undervaluation, strong positive economic fundamentals, and a new Fed chairman who is so far mostly saying and doing all the right things are buoying stock prices -- despite rising interest rates. Our interpretation of stocks as the "king of carry trades" continues to be vindicated. But the protracted period of equity undervaluation is likely to continue, broadly speaking, until two major risk hurdles are overcome. We need to see an "all clear" from the Fed, indicating that today's necessary normalization cycle won't become an unnecessary tightening cycle. And we need to see evidence that the GOP can reaffirm its commitment to the pro-growth policies that earned its majority position in the first place, in time to preserve that position in the November elections.

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