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MACROCOSM

Highs for Stocks, Lows for Sentiment

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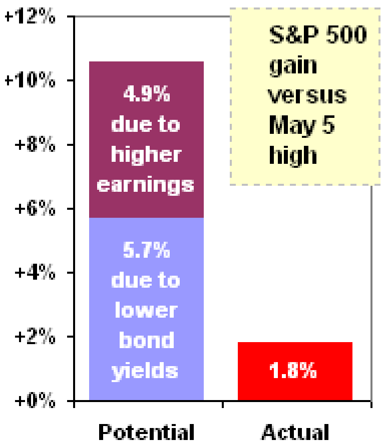
In our "first up, then down" strategy model, how long can "first up" last?

With stocks at new highs, our view of the sharp May/June decline as a buying opportunity has been completely fulfilled (see "The May 10 Inflection Point" June 12, 2006). As we had expected, continued growth in forward earnings has been a rising floor under stock prices. But stocks have had to be dragged kicking and screaming to new highs. The S&P 500 now stands 1.8% higher than at its previous high on May 5, yet consensus forward earnings have risen 4.9% over the same period. Thus the S&P 500's forward price/earnings multiple has actually *contracted* -- from 15.1 on May 5, to 14.5 presently.

Update to strategic view
US STOCKS: Stocks can still move higher as forward earnings continue to rise, especially with sentiment so poor. But cutting against that, the recent decline in long rates will be reversed as the Fed conditions the market to not expect rate cuts any time soon. When it ultimately becomes clear that the Fed will resume hiking rates with a vengeance, stocks will begin discounting substantial economic weakness. Timing will be event-driven, but ultimately the present recovery in stocks presents an intermediate term selling opportunity.
[see Investment Strategy Dashboard]

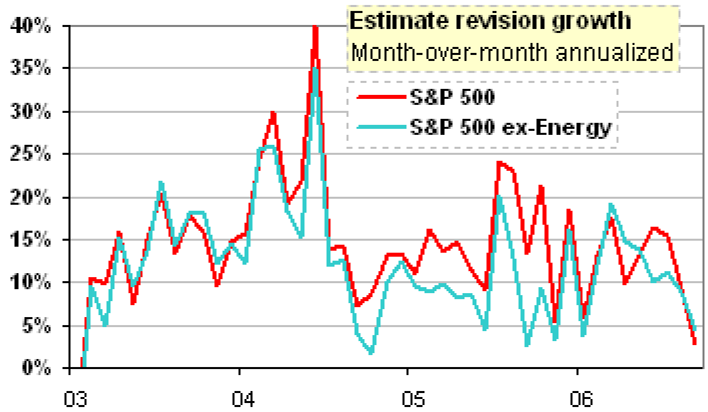


The cautious sentiment in equities can be seen even more sharply if we consider what has happened to long-term interest rates. Since May 5, the 30-year Treasury yield -- a proxy for the long-term discount rate applied to future corporate earnings -- has fallen 36 basis points. According to our valuation model, that alone should have lifted the S&P 500 to 5.7% above its May 5 high. Compounded with the 4.9% increase in forward earnings, the S&P 500 should now be 10.9% higher than the May 5 high. With only 1.8% having actually been gained, where's the missing 9.1%? Simple: it all went into the equity risk premium, which is far higher today than it was on May 5. The equity risk premium is now back at the high end of the elevated range in which it has persisted for the past four years.

In a contrarian way of thinking, this atmosphere of caution suggests that stocks have further to go on the upside in the near term. More fundamentally, we continue to expect the economy to reaccelerate, which would lift forward earnings, which would continue to function as a rising floor under deeply undervalued stock prices. At the same time, we have to consider the caution reflected in the elevated equity risk premium in light of our own caution about the intermediate-term prospects for economic growth. Near term, continued strong growth will keep earnings strong. But intermediate term, that growth will thwart the Fed's current forecast for sharp slowdown, one which the Fed thinks will serve to moderate inflation pressures. Faster than expected growth will lead the Fed to aggressive rate hikes that will likely be destructive to growth, more so than they would have been if the Fed had not paused in the first place (see

"Bernanke's Quagmire" August 7, 2006). The result will likely be a reversal of forward earnings growth -- and then the rising floor will become a trap-door. At the same time, higher discount rates will have to be applied to those lower forward earnings. Stock prices will have to move lower, unless there is a wholesale compression of the risk premium.

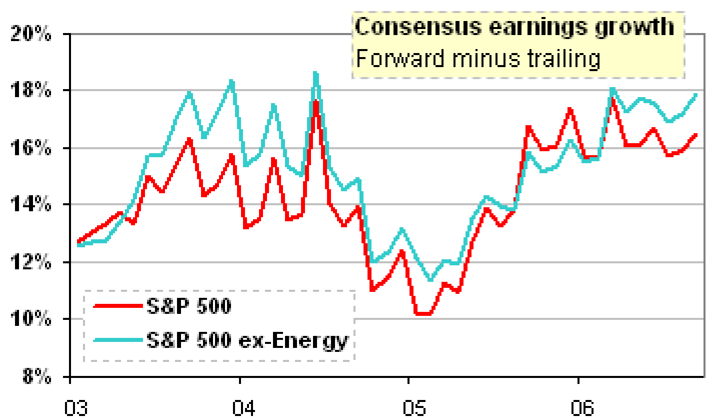
Thus our strategic model for stocks can be expressed, in essence, as "first up, then down." But how long can the "first up" part last -- is it perhaps already over?



ESTIMATE REVISION GROWTH SLOW -- ESPECIALLY ENERGY

While we do expect the economy to reaccelerate in the near term, the rising floor of forward earnings that has supported stock prices has been slowing down. One-year-ahead bottoms-up earnings estimate revisions for the S&P 500 are now running at the slowest pace of any time during this expansion. Some clients have remarked to us that this is even worse when rapid growth in the energy sector is removed, but actually the opposite is the case. As crude oil prices have fallen over the last two months, energy sector revisions been decelerating faster than those of the overall market. So forward earnings growth for the S&P 500 ex-energy is at the low end of the range, but not making new lows by any means. This bears close watching -- in the past two business cycles, the reversal of rising forward estimates gave remarkably well timed one-year-ahead recession warnings (see "The Out-of-Consensus Consensus" June 26, 2006).

Another risky element to the earnings outlook is today's very elevated consensus one-year-ahead earnings growth rate -- that is, the comparison of forward earnings to trailing earnings. As the pace of estimate revisions has slowed, it has remained positive -- but actual trailing earnings growth has slowed even more, and it turned negative month-over-month in September. As a consequence of these two factors, the consensus earnings growth rate has risen to almost its highest levels in this expansion at just under 18%, when the slower-growing energy sector is excluded (and at over 16% for the entire S&P 500). Even as the economy reaccelerates, it's hard to see how the implied consensus growth rate could get much higher than it already is, and it's easy to imagine it falling to more normal levels. For the entire S&P 500, forward earnings could fall by more than 16% in an environment in which actual earnings are nothing worse than flat.



CONSENSUS EARNINGS GROWTH STRONG -- ESPECIALLY EX-ENERGY

At the same time as we see the rising floor of forward earnings at some risk, we also expect the recent drop in long-term yields to be reversed. That would raise the discount rate applied to those earnings, and put equity valuations under even more stress. The reversal in yields could come quite suddenly, and indeed is likely already under way. Totally aside from our conviction that the Fed will eventually be forced to resume hiking rates, in the near-term we believe the Fed will engage in a campaign to correct the bond market's conviction that the next move will be to lower rates (see "The Frustrated Fed" September 29, 2006). Vice-chair Donald Kohn's speech last week was a loud shot in this campaign (see "Hoping Against Hope" October 5, 2006). It's working -- in the aftermath of Kohn's speech on Wednesday, when the September employment report was released on Friday, it seems the bond market finally encountered some macro data that it could not manage to interpret as dovish.

BOTTOM LINE: With the equity risk premium as elevated as it is, stocks are cheap. And with the economy reaccelerating, it's probable that stock prices can withstand the market's recognition that the Fed's next move won't be to lower rates. We see stock prices as likely to still move higher in the near term, but we have no deep conviction about it. It's only a matter of time, in our judgment, before markets will see that the Fed has bet wrong on a slowing economy acting to relieve inflation pressures -- and see that rate hikes will have to resume with a vengeance. The Fed's aggressive rate hikes will induce a significant slowdown, and when that prospect becomes obvious stocks will have to move lower. In the near term, as the Fed talks tough to condition the bond market, every word will foreshadow the day of reckoning to come -- we just don't know now exactly what event will move stocks to clearly glimpse the future (see "Foreshocks" September 7, 2006). Aggressive and nimble investors may want to stay exposed to stocks to play one last upmove. Those who don't want to try to time it that close should treat the present strength in stocks as an opportunity to be a scaled seller. TM